VOLUME 1

Tax Law Design and Drafting

Editor

Victor Thuronyi

INTERNATIONAL MONETARY FUND

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Preface

For over thirty years, the Legal Department of the International Monetary Fund has provided technical assistance in drafting tax legislation to member countries of the IMF. Because these countries belong to different legal traditions, have different political and administrative structures, and pursue different fiscal policies, each law has had to be specifically designed to fit the traditions, structures, and policies of each country. Yet, this continued empirical exercise in comparative law has led to a cross-fertilization of ideas, where the same issues have had to be faced in comparable contexts.

Initially, the demand for technical assistance came mainly from newly independent countries that wanted to modernize the tax laws they had inherited from the former colonial powers. More recently, countries in transition to a market economy, which have now become members of the IMF, have requested assistance to design tax laws "from scratch."

One of the benefits of comparative law is that it makes us aware that what is obvious or implicit in our national system either may not be so obvious or is explicitly condemned in other systems. For instance, in some countries courts have held that tax laws should be applied only within their literal terms, while in others the courts have had no difficulty interpreting the laws with a view to giving full effect to the lawmakers' presumed intent. Fortunately, in most cases, a substantial degree of consensus has emerged, and some general principles have been recognized that may guide legislators. The difficulty, however, is that there is no comprehensive treatise in which these principles can be found.

The objective of this book is to help fill this vacuum. In this respect, it is unique in the literature on comparative law. It is not intended to answer questions on existing laws or treaties. Its purpose is to identify legal issues that arise in the drafting of tax laws, including those that are often revealed only at the time of their subsequent interpretation and implementation, and the different solutions that have been given in national laws. It does offer some guidance while recognizing that there may be no perfect or uniform solution.

Most of the contributors to this book are staff members or consultants of the Legal Department of the IMF. Current and former staff members of the IMF's Fiscal Affairs Department have also contributed, reflecting the collab-

oration between these departments in technical assistance activity. All have brought to the IMF's technical assistance and to this book the invaluable benefit of their extensive experience acquired both inside and outside the IMF.

FRANÇOIS GIANVITI
General Counsel
International Monetary Fund

Acknowledgments

Although the editor of this book and the individual authors of each chapter are identified (generally listed alphabetically, where there is more than one author), the book is a collaborative effort of the authors. It also draws on the collective experience of a number of people who have assisted developing and transition countries with the drafting of new tax legislation over the past several years, including some who have not specifically participated as authors of particular chapters, but who may have written material drawn on in this book, Ward Hussey, Jinyan Li, Donald Lubick, Richard Pomp, and others.

Acknowledgment of all indirect contributions would be impossible. Individual chapters acknowledge persons who have contributed to them, by comment or otherwise. In addition, the editor is grateful to those who have commented on larger portions of the manuscript: Hugh Ault, Guy Gest, Minoru Nakazato, and Hans Georg Ruppe. Particular credit is due to Leif Mutén for the extensive comments he provided. Colleagues from the IMF Fiscal Affairs Department, Milka Casanegra de Jantscher, Dale Chua, Julio Escolano, John King, Anthony Pellechio, Janet Stotsky, Victoria Summers, Emil Sunley, and Zühtü Yücelik, and Legal Department, Tobias Asser, François Gianviti, William E. Holder, Ross Leckow, and Aarno Liuksila, have also contributed comments, ideas, and text. I am grateful to all these commentators, and the reader should be grateful, because the book is substantially better for their comments and corrections.

In addition to these commentators and listed authors, the book could not have been produced without the conscientious efforts of Melinda Milenkovich and Pam Sak, who provided expert legal research, checking of citations, editing, and reviewing sources in many languages; Carmen de Perignat, who, together with Melinda Milenkovich, worked on the bibliography of tax laws; and Heather Sera-Leyva, who provided expert word processing and editorial services. Elisa Diehl, of the IMF's External Relations Department, edited the final version and coordinated production.

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Introduction

This book arises from the substantial and ongoing tax law revision taking place in many developing and transition countries.[1] In some cases, laws have remained on the books for many years without major changes and need to be modernized. In most transition countries, the current laws are only a few years old and will require substantial revision as the tax system and the economy develop. Other countries are considering the adoption of new taxes (such as a value-added tax (VAT)). Officials responsible for tax legislation in developing and transition countries would like to study the tax laws of other countries to obtain models and guidance for drafting new laws. Unfortunately, the tax laws of most member countries of the Organization for Economic Cooperation and Development (OECD) have grown so complex that they are barely understandable to tax practitioners in the country concerned and are even more impenetrable to outsiders. This book responds to this need for information and seeks to present it in a way that is relevant and accessible.

The book grows out of the experience of the editor, in collaboration with most of the authors, together with other consultants, in drafting laws and advising on tax legislation for over two dozen countries (in Central and Eastern Europe, Africa, Asia, the Pacific, and Central and South America) over the past five years. The project responds to the suggestion of Richard Vann, who spent a year at the IMF Legal Department in 1990, that there was a need in developing and transition countries for nonprescriptive drafting materials that covered the major choices to be made in constructing a tax system. It represents an effort to distill from our collective experience, and from the tax laws of many other countries of the world, practical guidelines for drafting tax legislation that can be used by officials of developing and transition countries and by their foreign advisors.

While there is discussion of matters of special interest to developing and transition countries, paradoxically, most of the discussion does not focus on the peculiar problems of these countries, but rather is based on a comparative discussion of the tax laws of developed countries. This is because the mechanics of tax

[1]This term is used for brevity to refer both to developing countries and to countries whose economies are in transition to a market-based economy. Any such characterization of countries is imprecise and perhaps inappropriate in some respects, but it is used in this book as shorthand to distinguish in a general way between countries with highly developed, sophisticated tax systems and those whose tax systems are at an earlier stage of development.

law in developing and transition countries are not markedly different from those of developed countries, except that the laws tend to be shorter, and there are some differences in policy. An additional reason for the general scope of the discussion is that the book is intended to be broadly relevant, rather than being directed to a particular group of countries. Drafting tax laws for a particular developing or transition country requires studying a great deal of specific material in addition to the more general background provided in this book.

Because of its general nature, the book should also be of interest to students, academics, and practitioners with an interest in comparative tax law, although the book does not purport to be a complete treatise on this subject.[2] There is selective, but not comprehensive, footnoting. The emphasis in the footnotes is on giving practical examples of tax legislation, without reviewing all possible sources or all the available academic literature, on the assumption that those wishing to do further research can readily find the information they need.

The relative paucity of literature on comparative tax law was an important factor in determining to publish this book. To be sure, there are a number of comparative studies of specific topics, such as the annual study by the International Fiscal Association.[3] There are a number of studies of the tax systems of particular countries, and some comparisons of two or a few countries, but there exists to my knowledge no general treatise on comparative tax law. Professor Tipke's recent three-volume work[4] comes close, being a theoretical study with many references to non-German literature, but it is based on the German system. In the income tax area, a comparative study involving a wide range of structural issues in nine OECD countries is currently being produced by a group of authors under the leadership of Professor Hugh Ault.

This book consists of two volumes. Volume 1 covers general issues, some special topics, and major taxes other than income tax. Volume 2 deals with the income tax and also contains a bibliography of the tax laws of the world, a guide to foreign tax law research, a short bibliography of recommended books, and the index for both volumes. Although the two volumes are closely related, they can be used independently.

In no sense is the book intended to be the last word on the matters addressed. Rather, the emphasis is on identifying options and providing guidelines and examples so that the book may serve as a useful tool in the drafting of new tax laws. Any recommendations that are made are, first, the personal views of the authors and, in any event, are not intended to be applied indiscriminately. While the major taxes are covered in broad terms, a number of

[2]The approach of most of the book may be considered law reform rather than comparative law proper, inasmuch as it involves identifying useful ideas in various jurisdictions that could be transformed into part of the law of the jurisdiction for which one is drafting a tax law. *See* Alan Watson, Legal Transplants 9, 17 (1974).

[3]International Fiscal Association, Cahiers de droit fiscal international.

[4]Klaus Tipke, Die Steuerrechtsordnung (1993).

important matters (including fiscal federalism issues, taxation of cooperatives, and taxation of insurance, banking, and other financial institutions and products) are touched on only very lightly, if at all. Nor do we deal with customs duties or any number of other taxes that form part of the tax legislation of many countries. To attempt a more detailed discussion on the matters addressed and to include additional specialized topics and additional taxes, important though they are, would have indefinitely delayed publication. Nonetheless, the coverage is broad enough so that the book can be a useful starting point and guide on many practical questions.

Taxes have an important effect on the life of every member of society. Given the far-reaching effect of taxation and the complexity of taxes in modern societies, the development of tax reform proposals requires contributions from a number of disciplines:

- Macroeconomists and specialists in public finance can help determine required revenue targets, including cash-flow requirements.
- Economists who are specialists in estimating revenues from taxation can analyze whether any particular set of proposals is likely to meet the targets determined.
- Economists can help predict the effects on the economy of alternate tax structures. These include the effects of taxation on savings, investment, work effort, consumption choices, and alternate production methods, as well as macroeconomic effects.
- Tax administration specialists can evaluate the administrative mechanisms needed to apply particular proposals and can advise on the feasibility of various alternatives.
- Technical tax specialists (usually lawyers, accountants, or economists) who are familiar with the detailed operation of particular types of provisions can help design the rules needed to implement overall policy.
- Legislative drafters (lawyers who have experience in drafting tax legislation) can write the actual words of a proposed statute.

Chapter 1 discusses the need for the various professions to work together in designing tax legislation. Although close collaboration is important, each profession brings to bear its own specialized knowledge and approach. This book is concerned in particular with matters that are in the domain of lawyers,[5] and the legal viewpoint is emphasized. In particular, problems of drafting are discussed in detail, both as a general matter (chapter 3) and with respect to particular taxes and special issues. The overall legal framework for taxation (chapter 2) and the structure and design issues for particular taxes are examined from the point of

[5]Given the interdisciplinary nature of the field, this domain is shared with other disciplines with respect to many issues. The fact that the focus of the book is on legal issues should not be construed as an implication that these are the most important aspects of tax reform. Such matters as improvement of tax administration and the training of tax officials are critical but beyond the scope of this book.

view of comparative law. The treatment is of necessity general, focusing on matters that are likely to be of relevance to most countries, rather than exploring the peculiar legal problems of particular countries or groups of countries. The focus on legal matters means that the book cannot serve as a complete manual for the development of tax policy; references to literature on tax policy for developing countries are given in the bibliography (in volume 2).

The bibliography also lists a group of books that together represent a basic library for the study of comparative tax law. The list was intentionally kept short, the aim being to identify a library that could be acquired at modest cost and that would be sufficient to provide working answers to many questions.

In addition to consulting secondary sources, drafters of tax laws must consult the tax laws of other countries. It would be convenient if the tax laws of all countries were published in one place. Unfortunately, this has not been done on a comprehensive basis. As a step toward compiling this legislation, we have prepared a bibliography of current tax statutes of most countries (see bibliography of tax laws, in volume 2). Footnote references in this book are to abbreviations found in this bibliography. Although the bibliography is not complete, it is believed to be the most comprehensive bibliography of its nature currently available. For convenience, the statutes cited in volume 1 have been extracted from the bibliography and reproduced as a table at the end of this volume.

Because of the number of countries whose laws are referred to (some sixty jurisdictions), it has been impracticable to bring all the citations and discussions of particular countries' laws up to date as of some uniform date. Moreover, the purpose of these references is to furnish examples, not authoritative statements of the law in a particular country. Therefore, the reader should not rely on them as being necessarily up to date or complete.

The term "country" as used in this book does not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate, independent basis.

A Note on Terminology

With some exceptions, the terminology for legal categories of persons and things used in this book corresponds to that used in civil law countries:[6]

"Physical person" corresponds to "individual" in common law countries.

"Legal person"[7] is any person who is not a physical person.

"Movable property" corresponds generally to "personal property" in common law jurisdictions.

[6]For a detailed discussion of these terms, *see infra* ch. 3, sec. IV(D).

[7]*Persona juridica* in Spanish, *personne morale* in French, *yuridicheskoye litso* in Russian.

"Immovable property" corresponds generally to "real property" in common law jurisdictions.

Acronyms and Citation Style

The citation style in the footnotes generally follows *The Bluebook: A Uniform System of Citation* (15th ed. 1991). This uses some Latin terms that may be unfamiliar to those not accustomed to this style: *supra* (above, in this book), *infra* (below, in this book), and *id.* (short for *idem*, in the same work). Tax laws and countries cited in the footnotes are abbreviated: see the Table of Laws Cited. This table also contains a list of three-letter country abbreviations. States of the United States are abbreviated in standard form without reference to country. The following acronyms are used in the book:

CPI	Consumer price index
EC	European Community (predecessor of EU)
EEA	European Economic Area
EU	European Union[8]
FICA	Federal Income Contributions Act
FIFO	first in, first out
GATT	General Agreement on Tariffs and Trade (superseded by WTO)
ILO	International Labor Organization
IMF	International Monetary Fund
IRC	Internal Revenue Code
IRS	U.S. Internal Revenue Service
ISSA	International Social Security Association
LIFO	last in, first out
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Cooperation and Development[9]
PAYE	pay as you earn
SECA	Self-Employed Contributions Act
UN	United Nations
VAT	value-added tax
WTO	World Trade Organization

In numerical examples, "$" is used to refer generically to a country's local currency. If a reference to U.S. dollars is intended, US$ is used.

[8]As of the beginning of 1996, the 15 member states of the EU are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

[9]As of the beginning of 1996, the members of the OECD are the EU members plus Australia, Canada, the Czech Republic, Iceland, Japan, Mexico, New Zealand, Norway, Switzerland, Turkey, and the United States.

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Tax Legislative Process

Richard K. Gordon and Victor Thuronyi

> I do not have any doubt that when we proceed to shift the taxes around so that one set of taxpayers pays a lot more taxes and somebody else pays a lot less taxes, the people who benefit from it do not remember it very long. They tend to feel that it should have been that way all the time, and the people who are paying the additional taxes resent it very bitterly.
>
> —*Sen. Russell Long*

I. Institutionalizing the Tax Reform Process

A. In General

An enormous amount has been written on the ideal structure of tax laws or on specific technical problems in their design. Far less attention has been paid, both in the academic literature and in technical assistance, to the *process* of designing and drafting tax legislation in developing and transition countries.[1] In most member countries of the Organization for Economic Cooperation and Development (OECD), the tax legislative process has developed into a complex ritual whereby different groups compete to pass through the legislature their vision of an appropriate tax policy. A major tax bill in a country like the United States involves the input of thousands of professional lobbyists, policy analysts, lawyers, accountants, economists, and even ordinary citizens. By contrast, the tax legislative process is much simpler in most developing and transition countries, and has not had the opportunity to become established in many of these countries. Far fewer people are involved. This has advantages and disadvantages. A smaller group of well-qualified people can often do a bet-

[1]With some notable exceptions. *See, e.g.*, Michael McIntyre & Oliver Oldman, Institutionalizing the Process of Tax Reform: A Comparative Analysis (1975) and the sources cited therein; Richard Goode, *Obstacles to Tax Reform in Developing Countries, in* Taxation in Developing Countries 121 (Richard Bird & Oliver Oldman eds., 4th ed. 1990).

ter job in shaping a relatively coherent law. On the other hand, the lack of institutionalized experience with tax legislation means that the process often does not move forward smoothly, does not involve adequate consultation,[2] and often does not involve people with the necessary expertise at relevant stages of the process. Bureaucrats responsible for tax policy and their foreign advisors often see tax policy issues as a series of fires that need to be put out rather than as an ongoing long-term effort. The thesis of this chapter is that substantial improvements in tax legislation can result if those responsible for tax reform focus on process as much as on substance. The process by which tax legislation is developed can be of key importance in determining its quality, effectiveness, and acceptability.

This chapter offers recommendations for establishing a well-functioning tax legislative process. These recommendations are in the nature of an ideal, and they will not all be attainable in most countries. Those responsible will have to establish priorities and tailor the details of the process to the institutions of the particular country. We would like to make it clear, therefore, that the discussion below is not intended to propose a model to be rigidly applied in all circumstances. The personalities of specific individuals involved can also make an important difference, particularly when relatively few people are involved in tax policy formulation and drafting. Generalizations are therefore difficult to make, but some basic issues common to most countries can be identified.

Management of the tax legislative process involves both internal bureaucratic organization and procedure and domestic politics as well as, for many countries, relations with foreign technical assistance advisors. Given our personal experience and ongoing role as foreign advisors, we devote particular attention in this chapter to how foreign advisors might fit into the process.[3]

B. Identifying the Problems to Be Addressed by Legislation and Establishing the Pace of Reform

Problems in existing legislation can arise from different sources: new tax policy choices, changes in the economy, improved techniques of tax avoidance, and earlier bad choices in policy, drafting, and administration. To ensure that the tax laws are able to respond to each of these problems, the finance ministry should undertake a continuous review of tax laws.[4] A single review committee,

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[2]*See infra* sec. III.

[3]*See infra* sec. V.

[4]In most countries, the finance ministry is responsible for tax policy; this chapter is written on that assumption. Where another agency (most frequently, the agency responsible for tax administration) has this responsibility, the reference to the finance ministry should be changed to be to this agency. While there is no correct answer as to which agency should be responsible for tax policy, it is clear that problems arise where (1) this responsibility is not clearly assigned or (2) it is fragmented among different agencies. *See infra* sec. II.

drawing on a single person from each area of substantive tax expertise, could coordinate the process.

Such a review committee should maintain close contacts with the relevant parliamentary committees. It should be chaired by a senior member of the ministry, perhaps a deputy minister. Once a problem area is identified as requiring more detailed review, a working group should be formed to develop a response.

Because tax laws tend to be numerous and complicated, it would be impossible to subject them to complete review at all times. It should be the duty of the review committee to work closely with the tax administration, which is likely to be a primary source for notification of problems, and with research staff. In addition, it is important for the review committee to pay close attention to the private sector. Private sector professional associations may be an excellent source of information regarding problems.

Foreign advisors can also serve an important function in identifying problems. To the extent of their expertise in comparative law, they are often able to note difficulties that have arisen with similar rules in other jurisdictions.

The establishment of a review process should include an effort to keep the tax laws as stable as possible by minimizing the frequency of change. Frequent changes in tax legislation upset the expectations of investors and make it difficult for taxpayers to understand and comply with the laws. A careful consideration of proposed reforms can minimize the extent of changes needed by way of technical corrections and by way of budgetary compensation for hastily enacted, overly generous provisions.

C. Research Support

For tax policy working groups to function adequately, they need effective research support. Three important research areas are (1) estimating revenue, (2) surveys of current practice, and (3) comparative law.

1. *Estimating Revenue*

Overall estimates of revenue must of course be made as part of the budget process, which is beyond the scope of this discussion. But revenue estimates of particular provisions (or proposed provisions) can also be critical in the tax policy process. Revenue estimates can be an important weapon in opposing special tax concessions. By showing the cost of the concession, the revenue estimate brings home the extent to which taxes on others must be raised in order to pay for the concession. Unfortunately, estimating revenues is an extraordinarily difficult task. The data required include macroeconomic projections, a detailed understanding of the effects of a tax rule, and data on what private sector firms will be affected, including size and number. In many developing and transition countries, these data may be difficult to come by, and the actual numbers obtained

may not be very accurate. Nevertheless, it may be possible to come up with serviceable estimates. Sophisticated models for estimating revenues are now available for a number of jurisdictions, and private accountancy firms have designed tax calculator models for developing and transition countries.

2. *Surveys of Current Practice*

Experience with applying current law can suggest what tax reforms may be needed. One way of obtaining information about this experience is through surveys. They can be taken of those affected by a particular law, and can provide important information for those determining tax policy. Such surveys can be taken through interviews, written questionnaires, or sampling of tax returns. They can also involve reports from local or regional tax offices on their experience with administering the law. The ability of a research department to carry out surveys of current practice may be one of the most important of all research skills. Such survey capability not only allows those formulating tax policy to be aware of the issues and problems they are likely to confront, but also allows them to do so without relying too much on individual taxpayers in the private sector. Too much reliance on individual taxpayers for information can result in at the very least the appearance of impropriety or excessive influence by a few. To avoid this, surveys are typically anonymous.

3. *Comparative Law*

Much can be learned from studying the experience of other jurisdictions with their tax laws. Comparative studies can suggest positive directions for change, and can help avoid potential problems. Examining the laws of other jurisdictions can also help show how their rules might interact with proposed rules in one's own jurisdiction to affect transnational business and trade. Comparative legal analysis is one area in which foreign technical assistance advisors with the requisite experience can be of considerable value.

II. Interdisciplinary Nature of Taxation

As with many other areas of law, taxation must be approached in an interdisciplinary manner. Given the specialization of academic disciplines, this may create a problem in terms of who is involved in the process. It is unlikely that any one expert will be competent to advise on all aspects, and managers of the process should be aware of this. To design a package of tax reform proposals, a variety of areas of knowledge must typically be brought to bear. Economists should analyze the economic effects of different policy alternatives, as well as their revenue effects. Tax law experts should develop the detailed design of proposed rules, based on knowledge of the details of tax rules of different coun-

tries. Tax lawyers with drafting experience should work on the actual legislative language. Lawyers should also ensure the integration of proposed rules with the rest of the legal system (commercial law, constitution, etc.). Accountants should advise on the compatibility of proposed tax rules with accounting rules and practices. Experienced tax administrators should evaluate the administrative problems arising from proposed rules and suggest alternatives based on relevant experience (again, with comparative knowledge of practice of different countries where relevant).

Tax rules must seek to implement sound economic theory. They must, however, also be drafted in response to the realities of law, business practice, and bureaucracies, and the social and political settings in which these realities exist. This requires people from many disciplines to work together to craft rules that reflect the knowledge and experience of those disciplines. Local and foreign experts need to be able to work together as a team.

While it may not always be possible to mount such a full collaborative effort, steps can be taken to ensure that consultations among different experts are as extensive as possible. For example, a group consisting of at least one economist, one lawyer, and one public administrator could be identified and made jointly responsible for the final outcome of a legislative reform project. Careful follow-up at each stage should be required, from policy evaluation through drafting to implementation. And, wherever possible, careful consultations should be made with those people (from both public and private sectors where feasible) who are most familiar with the particular circumstances found in the jurisdiction.

The problem of lack of coordination in the tax policy process is not peculiar to developing countries. For example, in a comparison of the tax policy process in Australia, Canada, and New Zealand, Professor Brian Arnold argues that the three major components of tax policy formulation (policy development, technical analysis, and statutory drafting) should be performed by a single agency.[5] In Australia, problems arose because these functions were divided among three different units. The Tax Policy Division of the Treasury, consisting of about 30 individuals, mostly economists, is responsible for developing tax policy ideas. The Legislative Services Group of the Australian tax administration (about 60 professionals, mostly lawyers or accountants) is responsible for translating into legislation the tax policy proposals developed by the Treasury. The actual drafting is, however, done independently by about three full-time tax law drafters in the Office of Parliamentary Counsel. Arnold suggested that these three groups should be combined into one agency, similar to the practice in Canada, where the Tax Policy and Legislation Branch of the Department of Finance, with personnel consisting of economists, accountants,

[5]*See* Brian J. Arnold, *The Process of Tax Policy Formulation in Australia, Canada and New Zealand*, 7 Australian Tax Forum 379 (1990).

and lawyers, is responsible for all aspects of tax policy development, including the embodiment of policy in legislative language.[6]

III. Communication and Collaboration in the Tax Reform Process

A. Reform Considered by Working Groups Composed of Ministry Macroeconomists, Tax Policy Experts, Lawyers, and Administrators

Different groups are usually involved in the design and implementation of tax policy. In many ministries of finance these are divided into bureaucratic groups by discipline, including macroeconomists, tax policy experts, lawyers, and administrators, each with their own perspective and expertise. If all are not consulted on an ongoing basis, and instead a law is developed in a sequential manner, serious problems may arise.

Such a sequential process can result in general policies that cannot be easily translated into detailed rules, detailed rules that cannot be easily drafted, and statutes that cannot be easily enforced. In a world full of legal and institutional constraints, when basic policy is adopted, legal and administrative problems must be taken into consideration. Provisions, when drafted, should reflect what the policymakers really wanted to accomplish. The drafting process requires additional policy choices to be made, and to be worked out with tax policy specialists. Finally, provisions must, when administered, reflect both the policy choices made and the provisions as drafted. In other words, the administration must be able to implement the system as designed. Where a new law will result in substantial changes in administrative practice, it is particularly important to involve in the drafting process individuals with responsibility for administering the law. There must be a mutual understanding of precisely how the new rules will be applied. Otherwise, there is a real danger that those applying the new law will ignore it or misunderstand it.

On the one hand, there is a danger in studying a tax reform project to death. On the other hand, one can easily underestimate the complexity of the undertaking. In many countries, adequate staffing and expertise are simply not brought to bear in drafting legislation. Sometimes this is the result of bureaucratic infighting or individual sensibilities, and it is not always possible to remedy the human foibles that get in the way of a good coordinated effort. But where these can be overcome, the country stands to gain a great deal from an effective piece of legislation drafted by a coordinated team. This is not to say that a committee approach is the most appropriate at all stages. Sometimes it is

[6]*See id.* In the United States, tax policy formulation for the executive branch is the responsibility of the office of the Assistant Secretary for Tax Policy, which is staffed by lawyers, economists, and some accountants.

better for a small group, or a single person, to take on a problem, produce draft statutory language, and bring it back for consideration by a larger group.

Technical assistance advisors from each field can play an important role in advising the working group. Such advisors who have experience in other countries with regard both to particular tax laws and to the process of developing tax legislation can, at each step, provide comparative information of great utility. Advisors with comparative experience in tax administration can also be of considerable assistance at all stages of the working group's consideration of tax reform.

B. Consultation with Other Government Experts

While macroeconomists, tax policy specialists, lawyers, and administrators should be directly involved in designing and implementing tax policy, other government experts should also be consulted. This may include individuals within the ministry of finance as well as from other ministries. For example, units concerned with company law, accounting standards, and regulation of the financial sector will often have contributions to make to the development of tax legislation and should be kept involved. In some instances, the importance of these topics will require that experts be full members of the ongoing working group. In other cases, only an ongoing process of consultation will be required.

C. Consideration of Related Tax Issues by Different Working Groups

Problems can arise when related rules are developed by different groups. Depending on the size of the bureaucracy, tax policy responsibility may be divided among several divisions. It is essential for those involved in designing different aspects of a single tax, or of related tax rules, to consult with each other. It is not uncommon, for example, for a division that develops an individual income tax law to fail to communicate with another division working on a corporate income tax law; or persons responsible for accounting rules under the value-added tax (VAT) may not consult with those responsible for accounting rules under the income tax.

Because the interrelations among various tax laws are important, most particularly among the different parts of a single tax such as the income tax, no one group should be working in isolation from another. In most cases, this will mean that the chairs of each working group should consult with each other on a regular basis and that papers should be circulated among working groups.

D. Consultations with Parliament

Often, those involved in tax policy and implementation in the executive branch do not coordinate effectively with the legislative branch. This can

cause serious problems; parliament is unlikely to respond well if its views are not adequately taken into consideration during the preparation of the bill. The method and degree of coordination will differ from country to country, depending on the traditions of openness between the government and the legislature, the legislative process, and the constitution. Within local institutional constraints, the finance ministry should consult with appropriate members of parliament, including members of the parliamentary committees charged with consideration of tax legislation, and with parliamentary staff. It is often preferable for the chair of the ministry working group to consult directly with the committee chairs, and perhaps with a number of key committee members. It may be appropriate for one or more chairs, or other committee members or committee staff, to be members of the working group for a particular tax law reform.

Part of the process should be to educate all deputies, who will often know little about the tax system. The ministry should identify key deputies to be involved in the process of education, and ensure that they understand the issues and can communicate to their colleagues the choices to be made and their consequences. While such "education" may not equal "consultations," these efforts can result in a smoother legislative process once a bill is submitted for consideration.

During the consideration of the legislation, the working group, under the direction of the minister of finance, should provide guidance to parliament, and assist it in understanding all the issues involved and in making any required changes. The earlier consultation, if successful, should minimize the extent of the changes that have to be made at this stage.

E. Consultations with the Private Sector

Often tax policy analysts fail to consult adequately with business interests. Unless the government is aware of the activities and problems of business, it will not be able adequately to design effective laws or fix defective ones. Adequate consultations will usually mean communicating with the main accounting and law firms engaged in tax practice, and with a number of interested business persons, often through sectoral business associations. It is important to consult with these persons because (1) they are familiar with accounting and other problems involved in complying with the tax laws, (2) they can point out unfair or burdensome provisions, and (3) their support for legislation can be politically important.

Depending on the particular economy, the concerns and activities of transnational business and nonresident investors may be of great importance. Foreign tax advisors, particularly tax lawyers and tax accountants, can play an important role in assembling information from this part of the private sector. They often have practical experience in, and may have informal contacts with, transnational law firms, accountancies, and companies.

There are, however, dangers in involving members of the private sector too deeply in the formulation of tax legislation. Fundamentally, the interests of any one group in the private sector will often be opposed to the general public interest in raising revenue in an evenhanded manner. Their knowledge of the details of proposed legislation can also lead to provisions being defeated in the legislature, because of the political clout that they exercise. Accordingly, handling relations with them is a delicate matter.

Sometimes ministries deal with the problem by inviting selected tax practitioners to review drafts on a confidential basis. This practice raises problems of conflict of interest and favoritism (if some private practitioners learn about the government's proposals in advance while others hear only when they are announced). The better practice therefore is not to make representatives of the private sector privy to tax proposals until they are publicly announced. They can then comment on them on the same basis as any other citizen.

Where this is the government tradition, members of the private sector should still be surveyed to discover relevant facts. Sometimes formal surveys can be undertaken, while in other instances it may be possible to assemble a group of experienced lawyers or accountants who can give advice without being apprised of the details of the particular proposals. Members of the government may, however, be tempted to allow private sector representatives access to the formulation of the tax laws on the theory that this will be politically advantageous for them. If this occurs, the minister should not hesitate to support the public interest and to call for balance in the process. For example, it has been known for representatives of a business advisory council to sit down with those ministry of finance officials drafting a tax law and (with the approval of officials at the highest level) to require them to change any provision of the proposed law that they do not like. This should be absolutely forbidden. The private sector should be listened to, but should not be permitted to dictate the contents of proposed tax legislation, this being the responsibility of the government and the civil servants entrusted with representing the public interest.

Once tax proposals have been publicly announced, efforts should be made to organize seminars between tax officials and private sector representatives to discuss the provisions of the proposed law. If these are open to the public, then the problems of conflict of interest and favoritism alluded to above can largely be avoided.

F. Responsibility for Process of Tax Legislation

It should be the specific responsibility of the finance minister to ensure that the working groups are sufficiently inclusive. The minister should also be responsible for coordinating consultations with other government departments that are not a part of the working group, with representatives of those

in the private sector who are likely to be affected by the law, and the relevant parliamentary committees.

IV. Drafting Process

Once the details of proposed legislation have been agreed upon in a working group paper, a draft piece of legislation must be prepared. The drafter, who should be a member of the working group, should ideally be a lawyer thoroughly familiar with the laws and practices of the country. Ideally, the drafter should also be a specialist in the drafting of tax legislation. In some countries, such a person does not exist in the relevant government agency, and a foreign tax advisor can be used to do the drafting. In such cases, it is important for the advisor to work with a local drafter.

Once a draft law has been prepared by the finance ministry, there is usually a requirement that the justice ministry review the law for its legal adequacy, conformity with the constitution, and drafting style. If this review is conducted at the end of the process, mistakes can be introduced into the law. The lawyers in the justice ministry are typically not familiar with the operation of the tax laws. They may raise objections that are not well considered, but people in the finance ministry may be inclined to go along with them in order to move the law through the process, or may not themselves fully grasp all the implications of changes that the justice ministry suggests. A better approach would be to involve the justice ministry at an earlier stage, perhaps by including a person in the working group or by circulating group papers to the justice ministry, so that it becomes more familiar with how the tax law works and so that enough time exists to consider its concerns.

In OECD countries with common law legal systems, tax legislation is drafted by lawyers who are specialists in legislative drafting, and often subspecialists in drafting tax legislation. Depending on the legislative tradition, these may be found in offices attached to the legislature itself or in the finance ministry or equivalent. In the United Kingdom[7] and Australia, the task lies with the Office of Parliamentary Counsel (in the United States, the House Legislative Counsel and the Senate Legislative Counsel). In Canada, federal legislation is generally drafted by the Ministry of Justice, but tax legislation is drafted by the Tax Counsel Division of the Department of Finance.[8] In civil law countries, there is less of a tendency to regard legislative drafting as a specialty, with the result that laws tend to be drafted by personnel in the ministries rather than

[7]In the United Kingdom, there has been a recent move to involve tax lawyers from the private sector as consultants in the drafting process. *See* Jim Kelly & Robert Rice, *Lawyers Set to Breach Inner Sanctum*, Financial Times, Mar. 29, 1995, at 8.

[8]*See* Arnold, *supra* note 5, at 385.

by specialized parliamentary counsel. Nevertheless, those responsible for drafting tax laws tend to be lawyers.

V. Special Considerations in Using Foreign Legal Advisors

Many developing and transition countries have used foreign legal advisors in drafting their tax legislation. Depending on considerations of language, the qualifications of local personnel, the qualifications of the foreign advisors, and the desires of the officials responsible for developing a draft, the contribution of foreign advisors can involve commenting on a draft written by local drafters, producing a draft in collaboration with local drafters, or producing the entire draft themselves for the review of local officials. Varying situations can lead to the need for foreign advisors on drafting. Some developing countries may have considerable experience in administering taxes and may have some well-qualified officials in government service, but cannot afford to retain sufficient numbers of staff with the requisite experience in tax law, most of whom tend to leave government for the private sector. In addition, it will often not be efficient for a small country to maintain a complete staff of tax legislative drafting experts, particularly if the country only infrequently makes major revisions in its tax legislation. Talented staff can often be better assigned to other functions. Countries in transition also face the problem of attrition to the newly emerging private sector; in addition, although many officials in ministries of finance are highly educated, their degrees and experience tend to be in areas outside tax law. This is due simply to the fact that a market-based tax system is relatively new for these countries; the education and experience required to draft tax legislation will take years to develop. Other countries have well-educated and experienced tax staffs, but these do not necessarily have the extensive experience in comparative tax law that is required to draft measures to deal with more sophisticated problems; these countries may consult foreign experts on more limited questions.

For the above reasons, many countries have found it useful to consult foreign legal advisors in drafting tax legislation. Such advisors may have a great deal to contribute, assuming that they have considerable experience and knowledge of the detailed operation of tax law in different countries. There have been many successful cases where drafts were chiefly authored by foreign advisors. However, there have also been many cases where drafts prepared by foreigners have not been successful. While it is not possible to guarantee that the process will always work perfectly, some factors can be identified as leading to potential problems, even assuming that the foreign legal advisor is highly competent in tax law and has a good sense of tax policy. Awareness of these potential problems can alert the responsible officials to forestall them, thereby enhancing the likelihood of success of the drafting project.

One problem is language. It is desirable to use foreign experts who have at least the ability to read in its original language the law being drafted. Trans-

lation is a cumbersome process, and problems of ambiguity or terminology are often obscured by translators, sometimes even by those of the highest quality and longest experience. Moreover, the cost of translation and the time involved are such that the amount of local material that the foreign advisor can read will be limited. It is ideal to draft the text directly in the original language. It takes about three times the amount of work to draft a law in two languages (e.g., original in English and translation in the language of the country). An intermediate possibility that works if the foreign advisor does not know the local language well enough to draft in that language, but well enough to be able to read it, is for the foreign advisor and a local counterpart to first discuss the concept (perhaps with the help of an interpreter), then for the local counterpart to draft a provision. The foreign advisor can then review the draft and point out and discuss any problems, until the two jointly come to an acceptable version. Where the foreign advisor cannot read the local language well enough, he or she will not be in a position to guarantee the integrity of the draft, and local officials will be on their own to some extent. If the foreign advisor prepares a draft, it is helpful, instead of having a translator translate the draft, for the local official who prepares the local-language draft to be able to read and discuss the draft with the advisor.

A second problem lies in the appropriate choice of paradigm. Most developing and transition countries will choose to base a tax law on the legislation of one or more other countries. The extent of the similarity to foreign law will vary from case to case. In some cases, a few concepts and stylistic and organizational matters are borrowed. In other cases, large chunks of statutory language may be lifted. This process of borrowing from the tax legislation of another country often makes a great deal of sense. Tax legislation is so complicated that it makes no sense to reinvent the wheel each time a new tax law is written. By borrowing from the concepts of tax legislation in another country, the experience in interpreting and applying those concepts, and perhaps also particular legislative language, can be taken advantage of. For example, if the same statutory language is used, then the regulations, court decisions,[9] and practice in the other country in applying that language can be drawn on in interpreting the same language in the borrowing country. Of course, this does not mean that the same language should always be borrowed verbatim. Often there will be rules that the borrowing country does not wish to adopt. By studying the entire complex of legislation in the source country, the borrowing country can decide which portions of the tax law to adopt. The technique of borrowing from a foreign jurisdiction can be seen in a broader context, in that such borrowing tends to go on in other areas of law as well. To the extent that such borrowing has occurred elsewhere in the legal system, it may make sense to do so for the tax law as well.

[9]For example, courts in Commonwealth countries frequently refer to the judgments of other Commonwealth courts in construing statutes where the statutory language is similar.

Where a country wishes to borrow from the laws of country *X*, it is desirable, even essential, to use a foreign legal advisor who is familiar with the tax law of *X*. A national of another country will often not be equipped to do the job. Thus, in drafting an income tax law, what may be needed is not simply an expert on income tax law, but specifically a person who is an expert on the income tax legislation of a particular country or legal system.

This leads to an additional quality that a foreign legal advisor should have. The advisor should not be a person who seeks to impose the law of the advisor's own country on that of another country, or who, regardless of intentions, is equipped only to do so. Rather, it is important that he or she have a knowledge of comparative tax law. This will be less important where the country clearly wants to base its tax legislation on that of the advisor's home country. Even in this case, the foreign expert should not be one who unthinkingly will seek to impose all aspects of the legislation of country *X* on the borrowing country, but rather one who is capable of adapting this legislation to the particular circumstances of the target country. But where the country would appropriately model its legislation on that of a different country, or use a composite system, it can be disastrous to use an advisor who can work only within his or her own system.

A third problem that can arise when foreign advisors are used is lack of expertise in drafting. Often, foreign advisors are experts in tax law, but do not actually have substantial experience or skills in drafting tax legislation. Drafting is a subspecialty that most practicing tax lawyers or academics do not normally cultivate, often because it is reserved for specialists in their home countries. An individual who might be a perfect match in all other respects—knowledge of comparative law, language skills, knowledge of tax policy—might not be such a good drafter. In such a case, it will be important to team the advisor up with someone who has drafting experience. In any event, a drafter should not work in isolation, and a second person with experience in drafting should check over the work.

Fourth, unless he or she is stationed in the country for a substantial period, a foreign advisor will not know all the ins and outs of the country's legal system. Tax law is to a large extent a domain unto itself; therefore, much can be done without a detailed knowledge of the rest of the legal system. However, to produce a draft that is fully suited to the country's circumstances, it is necessary to consult local lawyers. The foreign advisor must take care to do so, lest a draft be produced that is legally inadequate or inappropriate. Ultimately, only local lawyers can give a legal opinion on the adequacy of the draft.

Fifth, the draft must be understandable both to local officials and to taxpayers and must respond fully to the tax policy goals that the lawmaker wishes to promote. The foreign advisor must take care to explain the draft fully so that it becomes the product of local officials as much as his or her own. Paradoxically, working in a different language can help here because the process of producing the draft in the local language forces the local officials writing the local-

language draft to understand the draft thoroughly. The process of drafting in the local language involves more than literal translation and in fact consists in writing a new draft. The foreign advisor who does not take the time and effort to make sure that every aspect of the draft is understood and accepted (or has been adequately rendered in the country's language if drafting is done in a different language) is not doing the job properly. Part of this function of explanation is the preparation of an explanatory memorandum, which should accompany most drafts. This would appropriately explain both how the new law functions and how it differs from current law. Detailing the differences from current law and practice is a particularly important part of the process of making sure that the new law corresponds to local needs.

Finally, the use of an outside advisor raises issues of the respective role of the advisor and of local officials. Where the ministry of finance uses its own staff to prepare legislation, the organizational hierarchy of the ministry makes it clear who is responsible for what. By contrast, where an outside advisor is used, the role of the advisor needs to be clarified. The best results occur when the foreign advisor is kept involved in all steps of the process up to final enactment. The foreign advisor should not have the power to make changes in a draft prepared by local officials—decisions on changes are a matter for local officials—but should have an opportunity to raise and explain problems that he or she perceives. When this has not been done, substantial errors have almost invariably crept into the legislation. It may be helpful for the government and the outside advisor to agree at the outset on the procedure to be followed by way of regular communication on drafting changes, so as to help ensure that this communication will take place.

2

Legal Framework for Taxation

Frans Vanistendael

> Taxation without representation is tyranny.
>
> —*James Otis*

Modern fiscal systems emerged in Western Europe and North America during the half century that followed the American and French Revolutions. Although modern income and turnover taxes did not yet exist, by the middle of the nineteenth century the basic legal framework for raising these taxes had been established and with it the foundation for the spectacular increase in tax revenue that would occur almost a century later, during and after World War I.

In general, the basic legal framework calls for taxation according to the rule of law. The fundamentals of this framework are that (1) a tax can be levied only if a statute lawfully enacted so provides, (2) a tax must be applied impartially, and (3) revenue raised by a tax can be used only for lawful public purposes, not for the prince's private ends. The rule of law contemplates that these principles will be enforced by independent courts.

The role of the courts is often referred to in this chapter. In some developing and transition countries, however, the judicial system does not, for various reasons, effectively fulfill its role. This is a substantial impediment to the rule of law in tax matters. A discussion of the ramifications, although important, is beyond the scope of this chapter.

In addition to these very general principles, the power to make tax laws is subject to several types of legal limitations. Their sources include (1) constitutional or other basic legal principles underlying an organized society, (2) international agreements, (3) interpretation of the tax laws by the courts, (4) the general framework of civil law and public law, and (5) the political structure of the country as a centralized or a federal state.

Note: Victor Thuronyi contributed to the writing of this chapter.

Tax laws must be drafted in the context of this legal framework, as it applies in the particular country in question. This chapter reviews the principles underlying this framework in general terms and on a comparative basis. Of course, where a particular country is concerned, further study will be needed to determine specifically how these principles are applied in that country.

I. Legal Foundation; Power to Make Tax Laws

The first principle is that any tax must have a firm basis in law. Much of the history of Western political movements has been based on opposition to arbitrary taxation. Parliamentary government in Britain evolved largely to constrain the monarch's ability to raise revenue. During the seventeenth century, the House of Commons, the elected lower house, was recognized as having the exclusive right to initiate revenue laws.[1] The American Revolution began as a protest against Britain applying taxes to the American colonies without the consent of their elected legislatures. As democratic government spread, legislative branches became the seat of power of the purse.

In light of this history, in most countries there is a basic constitutional principle that any act of taxation must have a legal basis. This principle means that no tax can be levied except under authority of a law.[2] In many countries, this principle is written into the constitution.[3] In others, the principle is not directly stated in the constitution, but is derived from another constitutional rule, as in Switzerland, where the principle of the legality of taxation is derived

[1]The main events ending taxing prerogatives of the king were the Petition of Rights of 1628 and the acknowledgment of the Bill of Rights in 1689.

[2]A special case is the customs tariffs and the minimum rates of the value-added tax (VAT) in the European Union, which are not determined by the national legislators, but proposed by the European Commission and decided by the European Council of Ministers. Even in this case, a statute would be needed to implement the decision in domestic law.

[3]*See* Bundes-Verfassungsgesetz [Federal Constitution] art. 18 (AUT); Grondwet [Constitution] art. 170 (BEL); Const. art. 91(3)(CAN); Grundlov [Constitution] § 43 (DNK); Hallitusmuoto [Constitution] § 61 (FIN); Const. art. 34 (FRA); Const. art. 23 (ITA); Const. art. 99 (LUX); Const. art. 106(2) (PRT); Const. art. 133 (ESP). Although art. 58 of the Constitution of the People's Republic of China provides that legislative power is exercised by the National People's Congress and its Standing Committee, there is no constitutional provision that requires a specific legal basis for imposing taxes. The National People's Congress can also delegate legislative power to the State Council, which is the highest executive organ of state administration. Xianfa [Constitution] art. 85. As a result, there has been some confusion as to which institution in China has the power to propose and approve tax laws. In 1985, the National People's Congress authorized the State Council to make provisional laws and regulations with respect to foreign investment and economic reform. *See* Decision of the Third Session of the Sixth National People's Congress on Authorizing the State Council to Formulate Interim Provisions or Regulations Concerning the Reform of the Economic Structure and the Open Policy (adopted Apr. 10, 1985), *reprinted in* Bureau of Legislative Affairs of the State Council of the P.R.C., 1 Laws and Regulations of the People's Republic of China Governing Foreign-Related Matters 391 (1991).

from the principle of equality of taxation.[4] In Germany, the legal basis for taxation rests on the combination of two other constitutional provisions: the provision guaranteeing personal freedom, which cannot be restricted except by law,[5] and the provision requiring a legal basis for any act of administration, including any administrative act of tax assessment and collection.[6]

Constitutions differ in the extent to which they allow the legislature to delegate tax law making authority. At one extreme, the principle of legality can mean that no delegation is permissible; at the other extreme, it can require only that taxes have a legal basis under the constitution, and if the constitution permits delegation of legislative power generally, then delegation is also permitted in matters of taxation. An intermediate position places limits on delegation, holding that for a tax to have a firm basis in law, its essential elements must be provided in an enabling law. Such elements would include, among others, definitions of taxpayer, taxable event or object of taxation, and tax base; tax rates; and basic rules for administration. This does not mean that all the details must be included in the law. As discussed below,[7] implementing regulations can be issued by the executive branch of government in accordance with the framework of administrative law. In some cases, the law may take the form of a decree by the executive branch, if permitted under the constitution.

Because a state must have revenue to survive, the constitution usually allocates, either explicitly or implicitly, some tax-levying authority to the central government, but the power to enact particular types of tax laws may be limited.[8] Such limitations can create serious problems for tax policy. For example, in the United States, the legislative powers of the Federal Government are limited to those specified in the Constitution. The Constitution provides specifically that the Congress has the "power to lay and collect taxes, duties, imposts and excises" through an act of Congress.[9] The procedure for enactment sets forth a special requirement for tax legislation: such legislation must originate in the House of Representatives.[10] Otherwise, the same procedure

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[4]Const. art. 4 (CHE); *see* Jean-Marc Rivier, Introduction à la fiscalité de l'entreprise 27 (1990).

[5]Grundgesetz [GG] arts. 1, 2/1 (DEU).

[6]*Id.* art. 20/3.

[7]*See infra* sec. IV.

[8]*See, e.g.*, Const. art. 245, seventh sched., List I, item 82 (IND) (parliament may establish taxes on income other than agricultural income); *id.* item 92A; *id.* List II, item 54 (parliament may tax the sale or purchase of goods where the sale or purchase takes place in the course of interstate trade or commerce, but other sales are subject to taxation only by the states); *id.* List II, item 53 (only the states may tax the consumption or sale of electricity). In 1976, Pakistan, which has a similar setup, amended its Constitution to grant to the Federal Government power to tax "the sales and purchases of goods imported, exported, produced, manufactured, or consumed." *See* Const. art. 142, fourth sched., item 49 (PAK).

[9]Const. art. 1, § 8 (USA).

[10]*Id.* art. 1 § 7. *Cf. supra* text accompanying note 1.

must be followed for tax laws as with any other laws. There is, however, a specific limitation on direct taxes, requiring these to be apportioned on the basis of population. This provision was held not to authorize enactment of an individual income tax.[11] When this was corrected by constitutional amendment, the Supreme Court read the amendment relatively narrowly, taking to itself the decision as to whether a statute taxed "income" within the meaning of the amendment.[12]

Although there is no written constitution in the United Kingdom, British tax law also respects the principle of legality on the basis of the prescription of "no taxation without representation" that was introduced in the Magna Carta in 1215. This principle was reiterated in 1628 in the Petition of Rights, which states that "no man be compelled to make or yield one gift, loan, benevolence, tax or such like charge, without common consent by act of Parliament." This principle is one of the cornerstones of Western democracies, in that the consent to be given by the representatives of the taxpayers in parliament is considered to be a democratic guarantee against arbitrary taxation by the government.

From the principle of legality, some countries have derived the principle of annuality,[13] according to which a tax law can only have effect for one budgetary year. This does not mean that all tax laws have to be voted by parliament every year, but that parliament must annually consent to the government's levying taxes in accordance with existing statutes for the next budgetary year. In most countries, this principle is accepted as a principle of budgetary law, rather than of tax law, and its specific operation will depend on the constitutional provisions and other laws governing the process for adopting the annual budget.

The general principle of the legality of taxation has in some countries given rise to another principle that the tax administration may not conclude an agreement on tax liability with the taxpayer.[14] This is because when the statute says that tax is due, it must be strictly applied, and it is not within the power of the tax administration to agree to reduce the amount of tax. In some countries, the prohibition of such agreements is based on the idea of the tax

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[11]*See* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

[12]*See* Eisner v. Macomber, 252 U.S. 189 (1920).

[13]*See* Grondwet [Constitution] art. 174 (BEL); Const. art. 47 (FRA) and Ordonnance No. 59-2 of Jan. 2, 1959, Portant loi organique relative aux lois de finances, art. 4, Dalloz, Législation [D.L.] 175 (1959); Guy Gest & Gilbert Tixier, Droit fiscal 33–34 (4th ed. 1986); Const. art. 81 (ITA); Const. art. 134 (ESP). In the United States, the Constitution requires congressional consent for any spending of public money, U.S. Const. art. 1, § 9, but does not require annual consent for taxation. Accordingly, if Congress withheld its consent to public spending, the Government would have to stop spending, but the liability of citizens to pay taxes would remain unaffected.

[14]*See* Const. art. 42 *quater* (CHE), *translated in* XIX Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1982) ("The Confederation is entitled to enact regulations, by means of legislation, against arrangements with taxpayers granting unjustified tax advantages").

law as being of public order.[15] This means that the tax law has a special status as a statute that is essential to an organized society, similar to that of criminal law, on which agreement between the police authorities and the criminal is not possible either.[16] This principle also plays an important role in the interpretation of tax laws by the courts.

II. General Principles and Limitations on Power to Make Tax Laws

A. Principle of Equality

The principle of equal treatment under the law applies not only to taxation, but to all laws. It can be viewed as an application of the concept of legality, under which the law must be applied without exception to all those in the same circumstances.[17] It has two meanings, one essentially procedural and one substantive. The procedural meaning is that the law must be applied completely and impartially, regardless of the status of the person involved. This means that no one may receive either preferential or discriminatory treatment in the application of the law or may be denied procedural rights to challenge application of the law to him or her.

The substantive meaning of the principle of equal treatment starts from the position that persons in equal circumstances should be treated equally. Without clarification, this principle does not mean very much, because it admits that people who are not in the same circumstances can be treated differently. Therefore, the question becomes whether laws are prohibited from using certain criteria to discriminate among persons. While the list of prohibited criteria differs among various jurisdictions, they usually include ethnicity, religion, and gender. The exact application of this prohibition against discrimination in a particular country will depend on (1) whether the courts are competent to strike down legislation as unconstitutional and (2) what kind of discrimination is prohibited under the constitution.[18] The principle

[15]This is the case in Belgium, although this principle has not been incorporated in the Constitution. *See also* Gest & Tixier, *supra* note 13, at 41; DEU AO § 85.

[16]As a consequence, the institution of plea bargaining (not contesting a charge of a lesser offense in order to avoid a charge under a major offense), which is well known in the United States, does not exist in these countries in respect of major offenses.

[17]In Switzerland, the principle of legality is considered an application of the principle of equality. *See supra* note 4.

[18]In most countries that have constitutional control by the courts, the constitutional court is competent to check whether a law violates any constitutional provision. This is the case in France, Germany, Italy, and the United States. In some countries, however, the constitutional court has limited control. This is the case in Belgium, where the Cour d'arbitrage can only check violations of the rule of equality and laws violating the constitutional distribution of power and the economic and monetary union of the country.

also requires that both the purpose of the unequal treatment and the means to effect it have a rational basis. For example, treating higher-income taxpayers differently by applying graduated rates satisfies both tests; it is rational both to conclude that a taxpayer's ability to pay increases with his or her income and to enact graduated rates as an implementing technique. While some approaches to tax legislation are clearly rational, many distinctions that tax laws draw are difficult to evaluate. Whether they are seen to violate the principle of equality depends on the level of scrutiny to which the rule is subjected.

The principle of equality has been applied in different ways by the courts of different countries to limit the power of the legislator. In France, the principle of equality before the law has been held to prohibit the denial of procedural rights to some citizens but not to others.[19] The Constitutional Court has also struck down distinctions drawn by the legislator on the basis that they did not rationally carry out a purpose of the statute in the public interest.[20] In Germany, the Constitutional Court has interpreted the constitutional guarantee of equality as calling for equal taxation of similarly situated persons. It has found, for example, the de facto unequal taxation of interest income (due to the absence of withholding) to be constitutionally impermissible, thereby requiring the legislature to enact measures to lead to more comprehensive taxation.[21] In Slovenia, the Constitutional Court has found a provision of the income tax law in violation of article 14 of the Constitution, which provides, "[a]ll are equal before the law."[22] The provision in question included reimbursed expenses of independent contractors in the tax base, thereby treating this class of persons unequally compared with employees. In Belgium, the principle of equality was held to prohibit taxing companies providing professional services (lawyers, accountants, tax consultants, physicians) at the maximum rate of the progressive rate scale of the

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[19]*See* Judgment of Dec. 27, 1973, Conseil constitutionnel [Con. const.], 1974 La Semaine juridique (Juris-Classeur Périodique) [J.C.P.] II, No. 17691. The decision concerned former article 180 of the General Tax Code, as amended by the 1973 Finance Act, which allowed taxpayers to contest the *taxation d'office*, under which income tax could be imposed on the basis of the taxpayer's expenditures, by proving that the expenditures were financed by resources other than taxable income. This opportunity for proof, however, was unavailable to taxpayers whose income exceeded a specified level. It was this denial—to one group of taxpayers only—of an opportunity to prove their case that the court found objectionable.

[20]*See* Judgment No. 95-369 of Dec. 28, 1995, Con. const., 1996 J.C.P. II, No. 67749. In this case, the court held that a reduction in the inheritance tax on an interest in a business, conditioned only on the heir retaining the property for five years, without being required to participate in the management of the company, discriminated in favor of one type of property without any rational legislative purpose. *See also infra* ch. 12, note 40.

[21]*See* Judgment of June 27, 1991, Bundesverfassungsgericht [BVerfG], 84 Entscheidungen des Bundesverfassungsgerichts [BVerfGE], No. 18, at 239 (DEU).

[22]*See* Decision of Dec. 1, 1994 of the Constitutional Court, Official Gazette of the Republic of Slovenia 143 (Jan. 13, 1995).

corporate income tax, thereby excluding these companies from the lower brackets, while all other companies could benefit from these lower rates. It was held that the circumstance that a company was engaging in professional services was irrelevant as a criterion to determine the tax rate applicable under the corporate income tax.[23] It should be noted, however, that although the Belgian principle of equality is similar to the equal protection clause in section 1 of the Fourteenth Amendment to the U.S. Constitution, the U.S. Internal Revenue Code (IRC) contains a specific provision denying the application of the lower corporate income tax brackets to personal services companies.[24] In the United States, this distinction is not considered a violation of the equality principle. The U.S. courts have generally been reluctant to strike down tax laws on the basis that they fail to provide equal treatment to equals.[25]

B. Principle of Fair Play or Public Trust in Tax Administration

The principle of fair play or public trust means that the taxation authority must not be allowed an unfair advantage in its dealings with taxpayers. Application of this principle suggests that (1) the authority must notify a taxpayer of any action the authority may take relating to that taxpayer, (2) during litigation, a taxpayer must be afforded all the rights of process allowed the authority, and (3) the authority must be bound by its interpretation of the law as applied to a taxpayer's particular situation. In most countries, these rules of fair play are part of the general administrative law. However, exceptions to these rules can be made when fair play does not suffer as a result. For example, an authority may take action without notice if it reasonably suspects that the taxpayer would destroy evidence or flee the jurisdiction.

This principle is somewhat contrary to the principle of public order, according to which the tax statute must be strictly applied under all circumstances.[26] Thus, the principle of fair play would hold that a taxpayer can rely on the statements of the tax administration if the taxpayer has given to the tax administration a full and fair representation of all the facts. The taxpayer can invoke the interpretation of the law by the tax administration even when such interpretation is erroneous. On the other hand, the principle of public order would suggest that if the tax administration erroneously applies the tax law, it

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[23]*See* Judgment of Dec. 14, 1994, Arbitragehof [Court of Arbitration], Belgisch Staatsblad [B.S.] No. 89/94, at 32.119 (Dec. 28, 1994).

[24]*See* USA IRC § 11(b)(2).

[25]*See, e.g.*, Nordlinger v. Hahn, 505 U.S. 1 (1992); *see also* Apache Bend Apartments, Ltd. v. United States, 964 F.2d 1556, 1562–69 (5th Cir. 1992). In that case, the court upheld so-called rifle-shot transition rules, which singled out particular taxpayers (usually those with effective lobbying representation) for transitional relief from the application of the Tax Reform Act of 1986. The court refused to find that this type of ad hoc transition relief was so arbitrary as to violate the constitutional requirement of equal protection of the law.

[26]*See supra* sec. I.

is entitled to correct this application, even if this were disadvantageous to a taxpayer acting in good faith. Since both principles are usually applied simultaneously, there are sometimes contradictory decisions in the courts. One way that courts strike a balance is by holding that a taxpayer is not entitled to the tax treatment following from the administration's erroneous interpretation, but that the taxpayer is not liable for penalties if he or she followed the administration's interpretation in good faith.[27]

The principle has in some cases been codified. In the United States, penalties are abated where the taxpayer relied on erroneous written advice furnished by an employee of the Internal Revenue Service.[28] In France, taxpayers can rely on a favorable administrative interpretation of tax statutes and regulations in contesting an assessment of deficiency in tax, even if the interpretation is contrary to law.[29]

The principle of public trust in the tax administration has also been used as a basis for preliminary rulings that can be issued by the tax administration on the application of the tax laws.[30]

C. Principles of Proportionality and Ability to Pay

The principle that tax liability should be based on the taxpayer's ability to pay is accepted in most countries as one of the bases of a socially just tax system. The principle of ability to pay is, for example, opposed to head or poll taxes, against which the British revolted in 1990.[31] Although it is used as a general principle for legislators in the design of the tax system, it is not included in the constitution of most countries and therefore cannot be enforced before the courts to limit the taxing power of the government.

The ability-to-pay principle is, however, constitutionally binding in some countries. For example, under the Italian Constitution, "everyone shall contribute to public expenditure in proportion to his resources."[32] The Italian Constitutional Court has held that ability to pay represents a specific applica-

[27]*See, e.g.*, the following U.S. cases: Druggists' Supply Corp. v. Commissioner, 8 T.C. 1343 (1947); H. Fort Flowers Foundation, Inc. v. Commissioner, 72 T.C. 399, 411 (1979).

[28]*See* USA IRC § 6404.

[29]*See* FRA LPF § 80A.

[30]*See infra* sec. IV(E).

[31]*See* Peter Passell, *Furor over British Poll Tax Imperils Thatcher Ideology*, N.Y. Times, Apr. 23, 1990, at D1.

[32]Const. art. 53, cl. 1 (ITA), *translated in* IX Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1987). Art. 53(2) of the Constitution of Romania provides that "[t]he legal taxation system must ensure a fair distribution of the tax burden." These provisions have probably been inspired by the French Déclaration des droits de l'homme et du citoyen of Aug. 26, 1789, which is an integral part of the present 1958 Constitution of France, and art. 13 of which says: "Pour l'entretien de la force publique, et pour les dépenses d'administration, une contribution commune est indispensable; elle doit être également répartie entre tous les citoyens, en raison de leurs facultés."

tion of the general principle of equality.[33] The Court held, for example, that an income tax whereby the income of married people is taxed jointly violates the principle of equality and the ability to pay.[34] The Spanish Constitution contains almost the same wording as the Italian.[35] The German Constitutional Court held that the principle can be derived from article 3(1) of the Constitution, which states that all persons shall be equal before the law. It has concluded, for example, that a provision in the income tax that placed a limit on the deduction for required maintenance payments was unconstitutional because it failed to provide an adequate deduction and, therefore, failed to base the tax on the taxpayer's ability to pay.[36]

The principle of proportionality is increasingly used by Western European courts in general and by the European Court of Justice in particular. It means that there must be some proportional relationship between the goals to be attained and the means used by the legislator.[37] In the tax area, this means that taxes cannot be excessive. Even when this principle is applied to taxation, it has not prevented governments from imposing progressive taxes. In some cases, progressivity of tax rates is enshrined in the constitution.[38] The principle of proportionality is generally interpreted as imposing only a marginal limitation on the taxing power of governments in the sense that they cannot impose confiscatory taxes.

In Switzerland, protection against confiscatory or excessive taxes is provided by a combination of article 22 *ter* of the Constitution, which guarantees private property to the citizen, and article 31, which establishes the freedom of commerce and industry. As in Switzerland, the principle of proportionality has not been enshrined in the German Constitution. It is implicitly recognized, however, by the combination of (1) the protection of personal freedom, which cannot be restricted except by law, so that each citizen is entitled to a

[33]*See* Judgment of July 6, 1972, Corte costituzionale [Corte cost.], 1972 Giurisprudenza Costituzionale [Giur. Cost.] I, No. 120, at 1289; Judgment of Apr. 19, 1972, Corte cost., 1972 Giur. Cost. I, No. 62, at 272; Judgment of Dec. 13, 1963, Corte cost., 1963 Giur. Cost. I, No. 155, at 1546.

[34]*See* Judgment of Mar. 26, 1980, Corte cost., 1980 Giur. Cost. I, No. 42, at 287.

[35]"All shall contribute to the sustenance of public expenditures according to their economic capacity through a just tax system based on the principles of equality and progressiveness, which in no case shall be of a confiscatory scope." Const. art. 31, § 1 (ESP), *translated in* XVIII Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1991).

[36]*See* Judgment of Feb. 22, 1984, BVerfG, 66 BVerfGE, No. 14, at 214.

[37]The European Commission on Human Rights has stated that tax legislation can be scrutinized under the European Convention on Human Rights on the basis of whether "a reasonable degree of proportionality existed between the means employed and the aim sought to be achieved." A., B., C., and D. v. The United Kingdom, App. No. 8531/79, 23 Eur. Comm'n H.R. Dec. & Rep. 203, 211 (1981). In this case, discussed in the text at note 47, *infra*, the Commission found that the retroactive application of the statute was reasonably related to the aim of the legislator (prevention of further use of tax shelters).

[38]Const. art. 53, cl. 2 (ITA); Const. art. 31, § 1 (ESP); Const. arts. 106, § 1 and 107, §§ 1, 3 (PRT).

decent subsistence minimum,[39] (2) the freedom to work or to exercise a profession,[40] and (3) the protection of property and inheritance.[41]

D. Principle of Nonretroactivity

The principle that tax statutes may not be applied retroactively can be justified on the basis that taxpayers should be able to make economic decisions with knowledge of their tax consequences and that it is unfair to provide tax consequences for an investment or other economic decision that differ from the tax treatment at the time the decision was made. Applied strictly, however, this principle would preclude any change in law, because any change, even if effective only in the future, affects the value of existing wealth. The balance is often struck by defining impermissible retroactive provisions as including only those with nominal retroactive effect, that is, those that affect a tax liability that has been fixed before the date on which the new law is passed. However, this is an arbitrary line, inasmuch as the economic effect of a tax change on existing investments does not closely correlate with the nominal retroactivity of the change.[42] The arbitrariness of any definition of nominal retroactivity suggests that even if legal protection is given against nominal retroactivity, the degree of protection can never fully correspond to economic reality. Because virtually every change in tax law has an effect on existing investments, the problem of retroactivity can be dealt with only as a policy matter and not by means of a formal legal rule.

In most countries, the principle of nonretroactivity is observed not as a legally binding principle (except for a few special cases, discussed below), but as a principle of tax policy that the legislature follows as it considers appropriate. For example, in the United States, some amendments of tax law (particularly those considered to be technical corrections) are made with retroactive effect;[43] by contrast, in other cases special relief is given against the application of tax changes to transactions in progress, even where the amendments are nominally prospective.[44]

In some countries, the principle of nonretroactivity is stated in the civil code.[45] In these countries, the tax law can provide for retroactive effect, when

[39]GG arts. 1/1, 2/1, 11 (DEU).

[40]*Id.* art. 12.

[41]*Id.* art. 14.

[42]*See generally* Michael J. Graetz, *Retroactivity Revisited*, 98 Harv. L. Rev. 1820, 1822 (1985).

[43]*E.g.*, Tax Reform Act of 1986, Pub. L. No. 99-514, § 1881, 100 Stat. 2085, 2914 (1986).

[44]*E.g.*, *id.* §§ 204, 633, 1277, 1312–17.

[45]*E.g.*, Code civil art. 2 (BEL); Code civil art. 2 (FRA). *See* Claude Gambier & Jean-Yves Mercier, Les impôts en France §§ 2280–81 (1991) (explaining that, under the civil code, in the absence of an explicit statement in the law, provisions take effect for taxable events occurring after publication in the official gazette; in the case of income tax, this means that if publication occurs before Dec. 31, the current year will be affected, since the taxable event is considered not to occur until the close of the year).

it specifically does so in exception to the civil code. However, if there are no specific provisions in the tax statute, the civil code's general principle of non-retroactivity will apply as the ordinary rule.[46]

The European Commission on Human Rights has dismissed a challenge to a retroactive tax law of the United Kingdom, holding that it did not violate the right of property under the European Convention on Human Rights.[47] In this case, section 31 of the Finance Act 1978 was applied retroactively to April 6, 1976, a date that preceded even the Government's announcement that it would legislate in this area. The provision in question denied a deduction for certain losses from tax shelters. The Government determined that retroactive application of this provision was necessary in order to deter tax-shelter promoters from devising new schemes. If anti-tax-shelter legislation were applied prospectively only, tax shelter promoters would be undeterred, because any scheme based on existing law would be valid for the period until new legislation were passed.

In countries where retroactive tax legislation is generally permitted, there are often some limitations for extreme cases. For example, the French Constitutional Court has stated that legislation may not be retroactively applied if it is penal in nature and that retroactively applied legislation generally may not affect individual cases that have already been decided by a court.[48] The U.S. Constitution also prohibits retroactive criminal legislation.[49] In the tax area, the U.S. Supreme Court has held that as long as the retroactive application of a statute "is rationally related to a legitimate legislative purpose," the retroactivity is permitted by the Constitution.[50]

In other countries, there are broader constitutional principles limiting the permissible scope of retroactive legislation. For example, in Germany there is no general constitutional or statutory rule on nonretroactive effect of tax laws. However, the German Constitutional Court has based the principle of nonretroactivity on the concept of the "Rule of Law,"[51] which includes the concepts of legal security[52] and public trust.[53] The German

[46]"The courts recognize that the legislator may deviate from the ordinary rule of non-retroactivity in light of an overriding interest of public order." Louis Trotabas & Jean Marie Cotteret, Droit fiscal 138 (1985) (ed. trans.).

[47]*See* A., B., C. and D. v. The United Kingdom, App. No. 8531/79, 23 Eur. Comm'n H.R. Dec. & Rep. 203, 211 (1981).

[48]*See* Judgment No. 86-223 of Dec. 29, 1986, Con. const., 1987 J.C.P. II, No. 20903; Judgment No. 95-369 of Dec. 28, 1995, Con. const., 1996 J.C.P. II, No. 67749 (court decisions may be overturned retroactively only for reasons based on the public interest).

[49]*See* Const. art. 1, § 9, cl. 3 (USA).

[50]United States v. Carlton, 129 L.Ed.2d 22, 31 (1994).

[51]*Rechtsstaatsprinzip*. Similarly, the Polish Constitutional Tribunal struck down income tax amendments that would have come into effect less than one month after the legislation was passed on the basis that taxpayers were given inadequate notice. *See* Janusz Fiszer, *Constitutional Battle over Poland's 1996 Personal Income Tax Rates*, 12 Tax Notes Int'l 246 (1996).

[52]*Rechtssicherheit*.

[53]*Vertrauensschutz*. *See* 1 Klaus Tipke, Die Steuerrechtsordnung 182–83 (1993).

Constitutional Court distinguishes between retroactive tax laws[54] and retrospective tax laws.[55] A tax law is considered to have retroactive effect when it affects transactions that have been closed in the past, that is, before the law was approved and/or promulgated by the legislator. The law has a merely retrospective effect when it affects the future transactions or legal positions that have not yet been closed. The Court requires a higher standard for retroactive laws, which with a few exceptions are prohibited in principle, while merely retrospective laws are permitted. The Constitutional Court held unconstitutional an amendment to the corporate income tax law passed in 1952 that was applied to the 1951 taxable year.[56] The prohibition against retroactivity under German jurisprudence is not absolute; retroactive legislation will be sustained where the taxpayer's reliance on existing law was not reasonable, where the resulting damage for the taxpayer is almost nonexistent, where existing law was unclear or technically deficient, or in certain cases of overriding public necessity.[57]

Even where there is no legal prohibition on retroactive legislation, in most cases, the legislature decides to pass tax legislation on a largely prospective basis. In fact, in many cases, the political process provides taxpayers with generous protection from the effects of tax legislation for transactions in progress or investments that have been made. In some cases, however, legislatures act retroactively in order to protect tax revenue.

The following are examples: (1) The government announces that the excise tax on alcohol will be increased. The higher rate is often applied to stocks on hand (including floor stocks at the wholesale or retail level) on the date of announcement, as well as to production after that date. Otherwise, consumers would buy alcohol in large quantities to avoid the higher tax. (2) A mistake is discovered in a tax law that, if left uncorrected, could lead to a substantial revenue loss. The mistake is typically corrected with retroactive effect. Otherwise, taxpayers could take advantage of the time before the legislature passes the necessary legislation to reduce their tax liability, thus losing considerable revenue for the budget. (3) The government proposes in October 1995 changes in the individual income tax for 1996. However, the legislature does not pass the bill until May 1996. Nevertheless, the new rules can be applied for the 1996 taxable year. This is a case where the law may be considered nominally not retroactive, but merely retrospective because the law is passed before liability for 1996 is determined (i.e., December 31, 1996).[58]

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[54] *Steuergesetze mit echter Rückwirkung.*

[55] *Steuergesetze mit unechter Rückwirkung, oder tatbestandlicher Rückanknüpfung.*

[56] *See* Judgment of Dec. 19, 1961, BVerfG, 13 BVerfGE, No. 26, at 261.

[57] *See* 1 Tipke, *supra* note 53, at 184, 195.

[58] *See id.* at 188.

Countries that allow retroactive tax legislation often apply a new tax law as of the date the bill was introduced in parliament. By setting an early date for the application of the tax law well before the final approval of the law by the parliament, the government prevents taxpayers from escaping the new tax provisions by rearranging their affairs during the period between the announcement of the new tax measures and the final vote in parliament. If the government announces the early date of application, the taxpayers will be warned about the new measures, so that they can take the tax consequences into account. Under such conditions, it can be accepted that the public trust of the taxpayer has not been violated.

In addition to the question of the retroactive effect of tax legislation, it is also important to consider legal restrictions on the retroactive application of delegated legislation.[59] Regulations and other normative acts interpreting tax legislation are typically applied with an effective date the same as that of the law being interpreted.[60] Otherwise, there would be the strange situation that the same law would be interpreted with one meaning up to a certain date and with a different meaning after that date. However, where a regulation provides a new rule of which taxpayers could not have been aware, it is often applied with prospective effect. This decision is typically left up to the body authorized to issue the normative act. For example, under section 7805 of the U.S. Internal Revenue Code, the Secretary of the Treasury decides the extent to which regulations will have retroactive effect.

E. Other Constitutional Limitations

Depending on the provisions of a country's constitution, various other limitations on the power to make tax laws may apply. Besides requirements for equal treatment of taxpayers already mentioned above, there may be prohibitions against the taking of private property, requirements of regional equality, prohibitions against taxing certain items or discouraging certain activities, or prohibitions against taxing an item twice. As a general principle, the constitutional provisions that limit legislative power will apply to tax legislation as to any other legislation.[61]

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[59]*See generally* John S. Nolan & Victor Thuronyi, *Retroactive Application of Changes in IRS or Treasury Department Position*, 61 Taxes 777 (1983). The German Constitutional Court applies its doctrine concerning retroactivity to regulations as well as to statutes. *See* Judgment of June 8, 1977, BVerfG, 45 BVerfGE, No. 6, at 142.

[60]*See* Gambier & Mercier, *supra* note 45, at § 2284.

[61]For example, in the United States, the power to levy taxes is subject to the general limitations on legislative power in the Constitution, such as the due process clause of the Fifth Amendment. In practice, U.S. federal tax legislation is very rarely found to be unconstitutional. An important exception is the Pollock decision. *See* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

For example, in Germany, the income tax provision subjecting the aggregate income of husband and wife to a progressive rate schedule in such a manner that a married couple could pay a higher tax than if they were taxed separately was held to violate article 6/1 of the Constitution, relating to protection of marriage and family.[62] Moreover, articles 1/1 and 14 of the Constitution are interpreted as allowing each citizen a decent subsistence income, so that the Government may not tax income below this minimum; as a consequence, the German Constitutional Court held that dependency exemptions under the income tax for 1983–85 were constitutionally insufficient.[63]

The constitutions of many countries contain provisions with respect to the freedom of speech and religion. In countries where the courts have the power to enforce constitutional provisions, these provisions are held to mean that the government may not hinder the exercise of these rights through taxation, for example, by imposing heavy taxes on churches.

In Germany and Switzerland, special taxes are levied for the financing of church activities. In Germany, the combination of article 140 of the Constitution and article 137(6) of the Weimar Constitution of 1919 allows the church to impose taxes on the members of their congregations, within the limits imposed by state law. However, articles 2/I and 4/I of the Constitution prohibit the states from granting authority to churches over nonmembers of their congregations, so that nonmembers cannot be subjected to church taxes. Since only physical persons can be members of a congregation, imposition of church tax on legal entities is prohibited in Germany. There has been a trend in recent years for people to deregister as members of a church, in order to avoid paying the church tax.

In Switzerland, cantons are entitled to impose taxes to cover the expenses of the churches; unlike in Germany, it is not the church that imposes the tax. However, article 49/6 of the Constitution provides that no person can be obliged to pay taxes for a church to which he or she does not belong. This provision is based on the freedom of thought and religion. Consequently, persons not belonging to a church are entitled to refuse to pay the tax. However, unlike in Germany, legal entities are not protected by this clause and can be subjected to taxes levied for the benefit of a church.

In many other countries (such as the United States), a church tax would be unconstitutional, because it would violate the constitutional rule of separation of church and state.

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[62]*See* Judgment of Jan. 17, 1957, BVerfG, 6 BVerfGE, No. 9, at 55; *see generally* 1 Tipke, *supra* note 53, at 380. Art. 6/1 of the Constitution of the Federal Republic of Germany provides: "Marriage and family shall enjoy the special protection of the state." VIII Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1994).

[63]*See* Judgment of May 29, 1990, BVerfG, 82 BVerfGE, No. 7, at 60, 85; Judgment of June 12, 1990, BVerfG, 82 BVerfGE, No. 12, at 198; 2 Tipke, *supra* note 53, at 697–98, n.431.

There are great differences from one country to another in the extent to which courts use constitutional grounds to strike down tax legislation. As the examples cited above suggest, the German Constitutional Court has been particularly active in testing tax legislation against constitutional principles. Inevitably, this has involved the Court in difficult-to-resolve problems and has made it an almost permanent player on the tax policy agenda. Germany furnishes an ironic contrast to the United States, where the Supreme Court has been rather reluctant to become involved in tax policy issues at the federal level, despite its activism in many other areas of the law. The Court has, however, been quite active in the area of restrictions on state tax legislation that flow from the Constitution, given their importance for the federal state. Most other countries where courts have the power to strike down unconstitutional legislation have generally shied away from invoking open-ended principles, such as equality, in the tax area, but have sometimes relied on relatively more formal criteria—particularly those involving competence to legislate—to strike down tax laws.[64]

F. Charters of Taxpayer Rights

Some countries have provided charters or declarations of taxpayer rights. These have taken various forms. Sometimes, they have been issued by the tax authorities. Such documents are generally declarative of existing law, without independent legal force. In other cases, there is an article of the administration law entitled "Rights of the Taxpayer,"[65] or there may be a bill entitled "Taxpayer Bill of Rights," which enacts amendments to the rules of tax procedure.[66] In this event, the rules have the same legal force as other provisions of the administration law. The main effect of these charters is to prohibit arbitrary practices by the tax administration against taxpayers.

In 1984, the Charter of Rights and Freedoms was established in Canada, and the rights of the taxpayer are summarized in the Declaration of Taxpayer Rights.[67] The tax authorities must act in accordance with the provisions of the tax law. If the action is not authorized under the tax law, it is invalid. If the action is authorized by the law, a taxpayer can challenge its constitutionality.

[64]The Constitutional Court of Guatemala read a provision of the income tax law as taxing an item of income twice and struck it down as violating a constitutional prohibition against double taxation. Cases Nos. 39-88 and 40-88, Corte de Constitucionalidad, *in* Leyes y Reglamentos de la Reforma Tributaria 83, 91–92 (Luis Emilio Barrios Pérez ed., 1989). *See also* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

[65]This is common in countries of the former Soviet Union. *E.g.*, KAZ TC art. 142.

[66]*E.g.*, Omnibus Taxpayer Bill of Rights Act, Title VI, Subtitle J, Pub. L. No. 100-647, 102 Stat. 3730 (1988) (USA) (codified as amended at 5 U.S.C. § 504 and scattered sections of 26 U.S.C.).

[67]Revenue Canada Taxation, Declaration of Taxpayer Rights (1984), *reprinted in* Vern Krishna, The Fundamentals of Canadian Income Tax 29 (4th ed. 1993).

As a result, taxpayers have sought protection under the law of privacy[68] and the right against illegal search and seizure.[69]

In Belgium, a taxpayer's charter[70] was voted in 1986, after the power of criminal investigation in tax fraud cases was transferred from the tax administration to the public prosecutor. The main effect of the taxpayer's charter was to prohibit tax officials from cooperating with the public prosecutor's office in criminal investigations, thereby also discovering unreported taxable income. In addition, the reporting of instances of tax fraud by the tax administration to the prosecutor's office became subject to a clearance by a high-ranking official of the central tax administration.

In France, the tax administration established a taxpayer's charter (*charte du contribuable*) by way of administrative practice.[71] In this document, the taxpayer's rights in case of an audit were stated. In 1987, the tax laws were amended to require the tax administration to provide the taxpayer with a copy of the charter before conducting an audit and conferring legal force on the provisions of the charter.[72] If the tax administration fails to commu-

[68]*See In re* James Richardson & Sons, Ltd. et al. and Minister of National Revenue, 9 D.L.R.4th 1 (1984), where the taxpayer sought protection under the law of privacy. Section 231(3) of the Canadian Income Tax Act, as it then was, gave the tax authorities the power to demand from any person any information "for any purposes related to the administration or enforcement" of the act. The tax authorities relied on this provision and required a company, which was a commodities futures market broker, to reveal the names and addresses of its customers for purposes of doing a feasibility study before introducing a new regulation on information reporting. The tax authorities guaranteed confidentiality of the data during the study. Neither the company nor any of its customers were under investigation at the time. The company refused to turn over the information and challenged the power of the tax authorities at court. The Supreme Court of Canada held that "a requirement of information under § 231(3) could only be made where the Minister was conducting a genuine and serious inquiry into the tax liability of specific persons." *Id.* at 1 (quoting case summary).

Section 231(3)(b) of the Income Tax Act, as it then was, authorized the Minister to require a lawyer to produce files relating to his client "within such reasonable time as may be stipulated" in a registered letter. In *In re* Joseph et al. and Minister of National Revenue, 20 D.L.R.4th 577 (1985), the Minister required the lawyer to produce the information "without delay." The court held that the Minister had no power to demand information to be produced without delay, which means immediately. *Id.* at 585. Parliament did not mean immediately when using "reasonable time." Tax authorities must give the lawyer some time to consider whether to produce the information because of the solicitor-client privilege protection.

[69]When a tax official is conducting an inspection or audit in a taxpayer's residence or business premise, the official must obtain consent from the taxpayer except where a search warrant is issued by a judge. In considering whether to issue a search warrant, the judge must be convinced that there is evidence of violation of the tax law committed by the taxpayer. The search warrant must also describe the premises to be searched. Otherwise, the search is illegal, and the documents seized will be illegal evidence, which cannot be used in a court of law.

[70]Law of Aug. 4, 1986, B.S. 11.408 (Aug. 20, 1986).

[71]*Note sur la charte du contribuable vérifié* (June 19, 1975).

[72]*See* FRA LPF art. L. 10.

nicate the taxpayer's rights contained in the taxpayer's charter, the audit is invalid.[73]

G. International Agreements

The authority of the state to legislate in tax matters may be limited by international treaties and agreements. These include (1) bilateral tax conventions, (2) multilateral treaties establishing free trade areas, (3) agreements related to the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), and (4) the Articles of Agreement of the IMF.[74] Depending on their scope, bilateral tax conventions may include specific limitations on the state's power to levy income taxes, payroll taxes, and estate and gift taxes on nonresidents. Treaties establishing free trade areas like the European Union or the North American Free Trade Agreement (NAFTA) restrict the ability to levy tariffs, frequently provide rules for indirect taxation, and may also provide income taxation rules. While typically not as important, other bilateral and multilateral treaties may also be relevant to some aspects of taxation. For example, treaties of friendship, commerce, and navigation usually have antidiscrimination clauses, which may restrict the state's income tax treatment of nonresidents.

A special application of the nondiscrimination principle has been made in several cases before the European Court of Justice. The Treaty of European Union prohibits discrimination on the basis of nationality in the areas of free movement of workers and the freedom to provide services,[75] the freedom of business establishment,[76] and the free movement of capital.[77] The European Court of Justice has held that even when the tax law makes distinctions that are generally considered to be relevant to such law, such as the

[73]*See* Thierry Lambert, Contrôle fiscal: Droit et pratique ¶¶ 523, 524 (1991).

[74]Subject to certain exceptions, Sections 2(*a*) and 3 of Article VIII of the IMF's Articles of Agreement prohibit IMF members from imposing restrictions on payments and transfers for current international transactions, or from engaging in multiple currency practices or discriminatory currency arrangements. These provisions prohibit the authorities of member countries from imposing some types of tax measures through their exchange systems. For example, the imposition by a member country of a tax on the purchase or sale of foreign exchange will give rise to a multiple currency practice (Article VIII, Section 3) if the tax exceeds 2 percent of the amount purchased or sold. Moreover, a restriction on payments and transfers for current international transactions (Article VIII, Section 2(*a*)) will arise if the authorities of a member country, before permitting a nonresident to transfer abroad the proceeds of current international transactions (e.g., profits and dividends), require the nonresident to pay outstanding taxes that are not related to the amount to be transferred. *See generally* International Monetary Fund, Selected Decisions and Selected Documents of the International Monetary Fund 354, 366–68 (20th issue 1995).

[75]*See* Treaty Establishing the European Economic Community [EEC Treaty] arts. 48, 59.

[76]*See id.* art. 52.

[77]*See id.* arts. 73b–73g.

distinction between resident and nonresident taxpayers, these distinctions violate the nondiscrimination principle if their application restricts basic freedoms.[78]

The same principle of nondiscrimination has been held to apply to international movements of goods, so that goods originating in a foreign country may not be subject to higher taxation than that applied to domestic goods.[79] Here, the European Court of Justice has held that even though the criteria used for distinctions in the tax law were not discriminatory in themselves, because they did not specifically refer to the foreign origin of goods, any criterion resulting in de facto restrictions on the entry of foreign goods violates the nondiscrimination principle.[80]

Such a position on nondiscrimination clearly restricts a country's power to make tax laws and should be kept in mind by those countries planning to enter any kind of customs union or common market organization.

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[78]In Case 270/83, Commission v. France, 1986 E.C.R. 285, the Court of Justice of the European Communities held that France discriminated against French branches of nonresident EU companies because it denied a tax credit on French-source dividends paid to such branch offices. The argument of the French Government, that it was justified in making an internationally accepted distinction between resident and nonresident taxpayers, was dismissed by the court.

In Case C-175/88, Biehl v. Administration des contributions du grande-duché de Luxembourg, 1990 E.C.R. 177, the Court of Justice held that a Luxembourg tax law violated the nondiscrimination rule because taxpayers who during the tax year moved abroad were denied the right to claim a refund on the excess withholding tax on wages when their annual tax liability on Luxembourg-source income, because of the move, fell below the amount of taxes on salary that had been withheld during their stay in Luxembourg. The court was of the opinion that this disadvantage would hit nonresidents much more often than residents and, therefore, constituted a violation of art. 48 of the treaty.

In Case C-279/93, Finanzamt Köln-Alstadt v. Schumacker, 1995 E.C.R. 225, the Court of Justice held that tax law may make a distinction between resident and nonresident taxpayers. However, for example, if both categories are basically under the same circumstances, when a nonresident earns the major part of his income in another member state, then resident and nonresident taxpayers should be treated identically. In particular, a nonresident taxpayer should benefit from the same refunds on progressive income taxes as a resident taxpayer.

[79]*See* The General Agreement on Tariffs and Trade art. 3, ¶ 2 (1986); EEC Treaty art. 95; Const. art. 1, § 10 (USA).

[80]In Case 433/85, Feldain v. Directeur des services fiscaux du département du Haut-Rhin, 1987 E.C.R. 3521, a French law imposing a progressive motor vehicle tax, depending on the horsepower of the car, was held to violate the nondiscrimination principle, because the progressivity of the rate scale, although couched in general terms, was structured in such a way that only foreign cars were subject to the highest tax brackets of the rate scale, resulting in a considerable tax advantage for French domestic luxury cars.

In Case 171/78, Commission v. Denmark, 1980 E.C.R. 447, the Court of Justice held that a lower excise tax on aquavit (the Danish national drink) than on whiskey and gin constituted a violation of the nondiscrimination principle, when in fact the largest part of aquavit was manufactured domestically, while whiskey and gin were mainly imported. The fact that the tax rule did not make a specific distinction between imported goods and domestically manufactured goods was considered to be irrelevant.

The European Convention on Human Rights is an example of another international agreement that limits legislative power, including taxing power. Article 1 of the first protocol to the Convention protects the right to property, but explicitly allows states a considerable measure of discretion with respect to taxation. As a consequence, the European Commission on Human Rights has been reluctant to strike down tax legislation as violative of the Convention; this has occurred only in a case where a tax infringed on the right to religious freedom.[81]

The Convention also provides for procedural rules with respect to the burden of proof and the right of defense in court cases. These provisions have thus far received only limited application in tax cases, chiefly where the case was in the nature of a criminal proceeding. But the European Court on Human Rights has recently ruled that they were applicable to administrative tax penalties, which were to be, from that point of view, assimilated to criminal penalties.[82] Several Western European countries are debating whether to extend all the legal guarantees for the defense in a criminal case to cases of administrative litigation.

III. Interpretation of Tax Laws

A. General Considerations

Like other laws, tax laws are general legal prescriptions. However, a legal rule cannot typically foresee all conditions of its implementation, so that ongoing interpretation (and frequently revision) of tax law is essential to its application. Occasionally, constitutions may provide for interpretation by the legislature itself.[83] The legislature may achieve a similar effect by amending an

[81]*See* Guy Gest, *La Convention et l'action des autorités fiscales*, 17 Droit et pratique du commerce international 546, 551 (1991).

[82]Case 3/1993/398/476, Benjenoun v. France of Feb. 24, 1994, série A, No. 284. *See* Guy Gest et al., *Convention europeénne des droits de l'homme et fiscalité—Bilan et perspectives*, Les petites affiches, No. 80 (1994).

[83]*E.g.*, Const. art. 205(1) (HND); Decreto No. 115 of Nov. 4, 1966, Gaceta No. 19,011 (HND); HND IR art. 24; Const. art. 58(3) (KGZ). In Belgium, Parliament historically had the power to make interpretive laws. *See* Law of Aug. 4, 1832 on the Organization of the Supreme Court (Cour de cassation), arts. 23–24, 1832 Pasinomie 469 (abolished by the law of July 7, 1865) (BEL).

Under art. 67 of the Constitution of the People's Republic of China, the Standing Committee of the National People's Congress has the power to interpret the Constitution and other national statutes. This means that authoritative interpretation of laws, including tax laws, is in the first place the work of the legislator. However, the Chinese tax legislator has not made frequent use of this power. Article 89(18) of the Constitution allows a delegation of this power to lower agencies. In this way, the constitutional provision is used to grant regulatory power to the Ministry of Finance and to the State Administration of Taxation to issue interpretive regulations of the tax laws, as is the practice in many countries of the Organization for Economic Cooperation and Development (OECD).

existing law, with or without retroactive effect. Such action by the legislature is common when the legislature wants to reverse the effect of the interpretation of a statute by a court.

Because in most countries implementation of tax laws belongs to the executive branch, the interpretation of tax law falls first to the executive branch, which issues regulations, decrees, circulars, and general rulings ("executive rules"). It also will apply law and interpretation to individual cases through individual rulings and decisions. However, executive rules must be in accord with constitutional and statutory law. Review of these rules is undertaken by independent courts. In addition to reviewing executive rules, courts interpret the tax law and apply it in specific disputes between the taxpayer and the tax administration. This means that the final interpretation of tax laws belongs to the judiciary.

The style in which courts interpret tax law will depend to a large extent on the way in which they interpret statutes in general. Statutory interpretation is a complex topic a full discussion of which is beyond the scope of this book. The style of statutory interpretation differs substantially from jurisdiction to jurisdiction.[84] For example, courts differ on whether they even admit that an issue of interpretation exists or that there is more than one possible way to read the statute.[85] They also differ on methods for ascertaining the intent of the legislature in enacting the statute, such as in their use of *travaux préparatoires* (legislative history). A general distinction can be made between common law countries and civil law countries. Courts in common law countries tend to pay close attention to the facts and exercise more freedom in their legal reasoning. Courts in civil law countries tend to take greater interest in the exact wording of the applicable rule and are generally more strict in their legal reasoning. While the style of interpreting tax statutes is influenced by the general approach to statutory interpretation, tax law presents some special considerations.

Everywhere in the world, even in common law countries, tax law has largely become a phenomenon of statutes and regulations. Oddly enough, the most detailed and elaborate statutory provisions are to be found in common law countries, such as Australia, Canada, and the United States. As a consequence, the application of the statutory rule is the basis for interpretation in common law as well as in civil law countries.

In all Western legal systems, the courts apply a specific method of legal reasoning, based on a systematization of facts and legal rules, in order to arrive at the concrete application of the tax law in the individual case. This type of legal reasoning is not peculiar to tax law, but common to all forms of statutory interpretation. Its objective is to answer the specific question whether a tax is

[84]*See* Interpreting Statutes: A Comparative Study (D. Neil MacCormick & Robert S. Summers eds., 1991).

[85]*See id.*

due from a specific taxpayer, by applying one or more rules to the facts that are thought to be relevant. The facts are often not raw physical facts but legally constructed facts, such as a company, a sales contract, or an inheritance. Legal reasoning selects and orders these facts, so that they become susceptible to the application of tax rules. The legal rules to be applied are also to be selected from a variety of norms. Again, legal reasoning selects and orders these norms, so as to arrive at a concrete application of the tax law. The objective of this process is to arrive at a clear result (i.e., a tax is due or not due). The objective is not to achieve reconciliation of the taxpayer with the position of the tax administration.

Two competing principles are of overriding importance in the interpretation of tax law. The principle of legality (under which no tax can be imposed except on the basis of law) can be interpreted as providing that a court should not extend the words of a taxing statute to impose a tax in circumstances where the language of the law does not clearly impose it.[86] This is the basic argument in favor of a literal interpretation of tax laws.[87] However, if tax laws are interpreted rather literally, taxpayers can often arrange their affairs so as to avoid taxation. The countervailing principle therefore is that in enacting a tax law the legislature intends that it be effective, that is, that it not be circumventable through artificial maneuvers. Moreover, the principle of equality would call for interpreting the statute so as to tax equally taxpayers in the same economic circumstances. The tension between these two approaches to interpreting tax laws has been resolved in different ways by courts in different countries; the review of country practice below focuses on this issue. In addition, the variety of tax cases has raised many issues of statutory interpretation that arise with tax laws as with other statutes and that cannot easily be summarized in such a brief discussion.

The basic questions with respect to the interpretation of tax laws considered below are therefore (1) whether tax laws should be interpreted strictly or in a wider sense by the teleological or analogical method, (2) whether the legal form of a transaction should take precedence over the substance of the transaction, and (3) whether tax laws should be subject to a kind of "economic" interpretation, which would not be applicable in other areas of law. These are partially overlapping questions and are answered differently by the case law of various countries.[88]

B. France

As a general rule, in the French tradition, tax laws are interpreted strictly. This is a consequence of the legality principle laid down in article

[86]*See* Gould v. Gould, 245 U.S. 151 (1917).

[87]*See, e.g.*, MacCormick & Summers, *supra* note 84, at 201, 346.

[88]For Canada, *see* Brian J. Arnold, *Canadian Federal Court of Appeal Rejects Purposive Statutory Interpretation*, 12 Tax Notes Int'l 382 (1996).

34 of the Constitution. A clear text cannot be interpreted beyond the literal meaning intended by the legislator.[89] Yet, the Cour de cassation and the Conseil d'Etat, the two highest courts to deal with tax cases, do not entirely share the same position on strict interpretation. The Conseil d'Etat, which deals with the majority of the more modern taxes (personal and corporate income tax and VAT), tends to have a more flexible attitude toward the interpretation of tax laws.[90] However, even under the traditional rule of strict interpretation of tax laws, the French courts have always recognized the authority of the tax administration to submit evidence about the real nature of the transaction, so that it should be requalified for tax purposes.[91] At about the same time, French courts developed the theory of abuse of law in civil law.[92] In general terms, this means that a person does not have the right to exercise the person's rights (e.g., property rights) in an abusive manner so as to injure others. This revolutionary theory would much later play an important role in tax cases in other countries.[93]

C. Belgium

Belgium has a long tradition of strict and literal intepretation of tax laws. This is based on the principle of legality enshrined in the Constitution: no tax is due unless imposed by a law, and the burden of proof for establishing that a tax is due lies with the tax administration. The quintessence of the Belgian jurisprudence on taxation has been laid down in a decision of the Cour de cassation[94] in which the court stated that a taxpayer is allowed to choose the "lesser taxed way,"[95] and that for the application of the tax laws a legal construction engaged in by a taxpayer will stand, even if the form of the construction is unusual, provided the taxpayer subscribes to all legal consequences of the taxpayer's construction. The holding of the court was based on the view

[89]"Tax laws should be interpreted strictly, and any doubt about the meaning of these laws should be resolved in favor of the taxpayer." 1 Demante, Principes de l'enregistrement No. 9 (1897) (ed. trans.).

[90]*See* Judgment of July 8, 1992, Conseil d'Etat, 1992 Recueil des décisions [arrêts] du Conseil d'Etat [Lebon], No. 88734, at 284; *see also* older cases cited in Jean-Jacques Bienvenu, Droit fiscal Nos. 52–54 (1987).

[91]This is the theory of "simulation," or sham. *See* Judgment of Feb. 15, 1854, Cour de cassation (civile), 1854 Recueil Dalloz périodique et critique [D.P.] I 51; Judgment of Dec. 11, 1860, Cour de cassation (civile), 1861 D.P. I 25; Judgment of Aug. 20, 1867, Cour de cassation (civile), 1867 D.P. I 337.

[92]*See* Judgment of May 2, 1855, Colmar, 56 D.P. II 9; Judgment of Dec. 2, 1871, Paris, 1873 D.P. II 185; Judgment of Nov. 22, 1889, Órleans, 91 D.P. II 120.

[93]*See* discussion under *Abus de droit in* Encyclopédie juridique, 1 Répertoire de droit civil 28 (Dalloz 1951); *see also infra* sec. III(E) for the discussion of interpretation of tax law in the Netherlands.

[94]Judgment of June 26, 1961, Cour de cassation, 1961 Pasicrisie Belge [Pas. Bel.] I, 1082.

[95]*La voie la moins imposée; De minst belaste weg.*

that the legal system as a whole is consistent and that if the taxpayer took all the legal consequences of the taxpayer's acts, the tax administration also had to recognize the tax consequences. The court held specifically that in tax law, there was no room for a principle of "economic reality."[96] Generally, it has also been held that there is no room for the application of abuse of law or *fraus legis* in the area of taxation. This jurisprudence stands for a high degree of legal security for the taxpayer. However, as tax planning became more aggressive, political pressure built up to introduce statutory antiavoidance rules and, in 1993, a general antiavoidance provision was enacted in the Income Tax Code.[97]

Yet the Belgian courts, like the French courts, applied the doctrine of "simulation" to some more traditional areas of taxation, such as gift and inheritance taxes. There is simulation when the legal act or instrument that is invoked by the parties against the tax administration does not correspond to the underlying legal relationship for which the parties have aimed. For example, a gift subject to substantial consideration to the benefit of the donor or a third party may be requalified as a sale.[98] A transfer of immovable property to a newly established company in exchange for shares, immediately followed by the sale of the shares to a third party, has been requalified as a transfer of the real property itself to the third party.[99]

D. Germany

Germany is an example of a country where the legislator and the courts have over time interfered with each other regarding the interpretation of tax laws. Already in 1919, when the general tax law (*Reichsabgabenordnung*) was introduced, it provided that the tax laws had to be interpreted in accordance with the economic interpretation;[100] the language was broadened in the *Steueranpassungsgesetz* of 1934.[101] The objective of introducing economic interpretation of the tax law as a guiding principle of interpretation was to get rid of the excessively restrictive interpretation of the tax law on the basis of

[96]*See* Judgment of Feb. 27, 1987, Cour de cassation, 1987 Pas. Bel. I, No. 387, at 777.

[97]*See* BEL CIR art. 344 (permitting the tax administration to set aside any legal qualification of an act or a transaction by a taxpayer, when the purpose of such act or transaction was tax avoidance, unless the taxpayer can show a legitimate business purpose).

[98]*See* Judgment of Dec. 6, 1883, Leuven, Recueil général de l'enregistrement et du notariat [Rec. Gén. Enr. Not.] 10.272; Judgment of Jan. 4, 1900, Brussels, Rec. Gén. Enr. Not. 13.221; Judgment of March 3, 1912, Brussels, Rec. Gén. Enr. Not. 15.129.

[99]*See* Judgment of Dec. 19, 1962, Brussels, Rec. Gén. Enr. Not. 20.640; Judgment of Mar. 26, 1905, Gent, Rec. Gén. Enr. Not. 20.895.

[100]*See* DEU Reichsabgabenordnung of 1919 § 4. *Cf.* ARG Law 11,683, § 11. ("In the interpretation of this statute . . . purpose and economic meaning ought to be considered" (ed. trans.).)

[101]DEU Steueranpassungsgesetz § 1/II (according to which the interpretation of the tax law had to consider "the social viewpoint, the purpose, and the economic significance of the tax laws and the development of the (economic) relationships" (ed. trans.)).

concepts and categories of civil law.[102] Particularly between the two world wars, the *Reichsfinanzhof* was keen on furthering a wide interpretation of tax law. Economic interpretation became an instrument in extending the tax law to fill gaps and loopholes by analogical interpretation.[103]

The use of economic interpretation as a guiding principle in the interpretation of tax law has gradually been abandoned by the Federal Tax Court of Appeal, and the pre-eminence of the use of civil law concepts in tax law interpretation has been re-established.[104] At the same time, the German Constitutional Court has been less clear in its decision on strict or extensive interpretation of tax law. Sometimes, it has spoken out in favor of strict interpretation and against the economic interpretation of tax law;[105] at other times, however, the same court has decided in favor of "judicial development of the law."[106] When the new general tax law was adopted in 1977, the general "economic meaning" clause in the *Steueranpassungsgesetz* was not renewed.[107] At the same time, a few specific and one general antiabuse clauses were introduced so as to give the courts more leeway in the interpretation of tax law, particularly in cases of abuse of legal constructions.[108]

E. Netherlands

Like France and Germany, the Netherlands at an early stage adopted a general antiavoidance provision.[109] However, for quite a long time, this statutory provision on the interpretation of tax law did not influence court decisions

[102]In Germany, this narrow and literal interpretation was called *Begriffsjurisprudenz* (conceptual jurisprudence) and subject to attack by the end of the nineteenth century. *See* Karl Larenz, Methodenlehre der Rechtswissenschaft (1983).

[103]*See* 4 Reichsfinanzhof Entscheidungen 243, 252; 6 Reichsfinanzhof Entscheidungen 292, 298.

[104]*See* Bundesfinanzhof, 1969 Bundessteuerblatt II 736, 737; Bundesfinanzhof, 1976 Bundessteuerblatt II 246.

[105]". . . das Steuerrecht wird von der Idee der 'primären Entscheidung des Gesetzgebers über die Steuerwürdigkeit bestimmter generell bezeichneter Sachverhäte' getragen und lebt dementsprechend 'aus dem Diktum des Gesetzgebers.'" Judgment of Jan. 24, 1962, BVerfG, 13 BVerfGE, No. 32, at 318, 328 ("tax law is based on the idea of the 'primary decision of the legislator concerning the tax treatment of certain generally defined circumstances' and therefore draws breath 'from the statement of the legislator' " (ed. trans.)).

[106]"Der finanzgerichtlichen Rechtsprechung ist es insbesondere nicht von vornherein verwehrt, im Wege der Rechtsfortbildung veränderten wirtschaftlichen Situationen Rechnung zu tragen. . . ." Judgment of Mar. 12, 1985, BVerG, 69 BVerfGE, No. 12, at 188, 203 ("Judicial decisions in fiscal law are not prohibited from giving significance to changed economic circumstances by way of development of the law . . ." (ed. trans.)).

[107]According to Tipke, this was because it was considered unnecessary, the approach of *Begriffs-jurisprudenz* (*see* note 102 *supra*) having been abandoned. *See* 3 Tipke, *supra* note 53, at 1239. DEU AO §§ 40–42 does contain a few specific antiavoidance provisions, some of which may be interpreted as the continuance of economic interpretation. These provisions, however, have a clear legal meaning.

[108]*See* discussion of antiabuse legislation *infra* sec. III(I).

[109]This provision, called *Bevordering van de richtige heffing*, was later incorporated in the General Tax Law. *See* NLD AWR art. 31.

because, at about the same time, the Supreme Court introduced the *fraus legis* doctrine into tax law.[110] According to this doctrine, any legal construction resulting in a factual situation that is effectively subject to tax should be similarly taxed if so required by the purpose of the tax law. Originally, the legal construction was set aside under the *fraus legis* doctrine only when tax minimization was the exclusive reason for the legal construction.[111] Gradually, however, the case law developed the doctrine that the legal form of the transaction would be set aside when the tax motive was the dominant or decisive reason for the transaction.[112] Whether the tax motive is the dominant reason for the transaction is determined not by the subjective intent of the taxpayer, but by objective facts to be evaluated by the judge. It means that if the taxpayer has objective nontax reasons for the transaction, it will stand the test of *fraus legis*. In this way, the Dutch courts still maintain the right of the taxpayer to arrange his or her affairs in such a way as to minimize tax liability, provided that the validity of the legal form is well established.[113] The *fraus legis* doctrine has been considered more than adequate to permit the courts to strike down artificial legal constructions, so that in 1987 the Minister of Finance decided to render the statutory antiavoidance provision inoperative, although it is still on the statute books.

F. United Kingdom

The U.K. tax system has no general statutory antiavoidance provision. Interpretation of tax statutes used to be controlled by the case *IRC v. Duke of Westminster*, where the court stated:

> Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.[114]

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[110]*See* Judgment of May 26, 1926, Hoge Raad [HR], 1926 Nederlandse Jurisprudentie [N.J.] 723. The Swiss courts have applied an interpretation of tax law that is very similar to the Dutch theory of *fraus legis*. There is an abuse of law when the legal form of a transaction is unusual, it was entered into with the intent of obtaining a tax benefit, and the benefit must effectively have been realized. *See* Jean-Marc Rivier, Droit fiscal suisse: L'imposition du revenu et de la fortune 61 (1980); Ernst Höhn, Steuerrecht 17 (1972).

[111]*See* Judgment of July 22, 1982, HR, 1982 Beslissingen Nederlandse Belastingrechtspraak [B.N.B.] 242.

[112]*See* Judgment of July 11, 1990, HR, 1990 B.N.B. 293.

[113]*See* Judgment of Dec. 19, 1990, HR, 1990 B.N.B. 121. A more recent case is discussed *in* Dick Hofland & Kees van Raad, *Dutch Consolidated Income That Erodes Interest Payment to Foreign Parent Company Is Not an Abuse of Law*, 11 Tax Notes Int'l 1143 (1995).

[114]Commissioners of Inland Revenue v. Duke of Westminster, 1936 App. Cas. 1, 19, 19 T.C. 490. For a comparative study of the interpretation of tax laws in France and the United Kingdom, *see* Stefan Frommel, *United Kingdom Tax Law and Abuse of Rights*, Intertax 54 (1991/92); *L'abus de droit en droit fiscal britannique*, Revenue internationale de droit comparé 585 (1991) (same paper in French).

This is generally considered to be the leading case for literal and strict interpretation, although the latter principle had already been formulated as follows in an earlier case:

> [I]n a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.[115]

However, in 1981, *W.T. Ramsay Ltd. v. Inland Revenue Commissioners* was decided.[116] In this case, the House of Lords struck down a tax-planning device on the basis that it was entitled to look at the overall result of several transactions and need not give tax effect to every single transaction.

> [T]he fiscal consequences of a preordained series of transactions, intended to operate as such, are generally to be ascertained by considering the result of the series as a whole, and not by dissecting the scheme and considering each individual transaction separately.[117]

This doctrine was further developed in *Furniss v. Dawson*, in which the step-transaction doctrine and the commercial purpose doctrine were formulated as follows:

> The formulation, therefore, involves two findings of fact: first whether there was a preordained series of transactions, ie [sic] a single composite transaction; second, whether that transaction contained steps which were inserted without any commercial or business purpose apart from a tax advantage.[118]

More recently, the House of Lords has limited the scope of the business purpose doctrine and the step-transaction doctrine in a series of cases.[119] The court decided that where two courses of action are open to the taxpayer and are actively considered by him, the Government could not deprive him of the tax benefit of one of the alternatives.

> It is one thing for the court to treat as a fiscal nullity a purely artificial step which will inexorably be followed by one or more others so as to achieve the desired end result. It is quite another for the court to treat as a fiscal nullity a step which had a commercial purpose in addition to tax avoidance and which in reality at the time it was taken might not have been followed by the other steps.[120]

[115]Cape Brandy Syndicate v. Inland Revenue Commissioners, [1921] 1 K.B. 64, 71, 132 T.C. 358, 366.

[116][1981] 1 All E.R. 865.

[117]Furniss v. Dawson, [1984] 1 All E.R. 530, 532 (comments of Lord Fraser of Tullybelton on the *Ramsay* case).

[118]*Id.* at 543.

[119]*See* Craven v. White, IRC v. Bowater, Baylis v. Gregory, [1988] 3 All E.R. 495 (1988).

[120]Craven v. White, [1985] 3 All E.R. 125, 155.

This decision was confirmed a few years later, together with associated cases, and Lord Jauncey succinctly stated the position of the House of Lords on tax avoidance:

> I conclude my analysis of the three cases by emphasizing that the *Ramsay* principle is a principle of construction, that it does not entitle the courts to legislate at large against specific acts of tax avoidance where Parliament has not done so and that at the end of the day the question will always be whether the event or combination of events relied on amount to a chargeable transaction or give rise to allowable relief within the meaning of the relevant statutory provisions.[121]

Now, the question is how long it will take before the Inland Revenue will decide that statutory antiavoidance measures are in order, as has been the case in Canada and Australia.[122]

G. Australia

In Australia, interpretation of the tax laws was for a long time dominated by literal and restrictive interpretation along the lines of *IRC v. Duke of Westminster* in the United Kingdom. While the British courts have been gradually taking a more flexible position on interpretation of tax law, the Australian courts persisted in their literal interpretation, thereby extending the doctrine of *Duke of Westminster* to all kinds of modern and complicated tax planning schemes, and implementing in fact a policy that favored the taxpayer. In *Investment and Merchant Finance Corp. Ltd.*, this literal and strict interpretation was based implicitly on the principle of legality:

> It is, of course, true that it is because company dividends are rebatable under s.46 that dividend-stripping is so attractive, and, if it be thought that this is a practice which should be checked, it is to that section that Parliament may choose to direct some of its attention. It is not for the courts, however, to depart from Parliament's clear statement. . . .[123]

In 1976, the Privy Council decided under New Zealand tax law the following:

> [I]t is not the economic results sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it.[124]

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[121]Craven v. White, [1988] 3 All E.R. 495, 542.

[122]*See infra* sec. III(G).

[123]Investment and Merchant Finance Corp. Ltd. v. Federal Commissioner of Taxation, 125 C.L.R. 249, 265 (1971); *see also* Curran v. Federal Commissioner of Taxation, 131 C.L.R. 409 (1974); South Australian Battery Makers Proprietary Ltd. v. Federal Commissioner of Taxation, 140 C.L.R. 645 (1978).

[124]Europa Oil v. Inland Revenue Commissioners, [1976] 1 All E.R. 503, 508 (Lord Diplock).

Chief Justice Barwick, who has been held responsible for the extent to which the High Court developed the strict interpretation of tax laws, stated his opinion as follows:

> It is for the Parliament to specify, and to do so, in my opinion, as far as language will permit, with unambiguous clarity, the circumstances which will attract an obligation on the part of the citizen to pay tax. The function of the court is to interpret and apply the language in which Parliament has specified those circumstances. The court is to do so by determining the meaning of the words employed by Parliament according to the intention of Parliament which is discoverable from the language used by the Parliament. It is not for the court to mould or to attempt to mould the language of the statute so as to produce some result which it might be thought the Parliament may have intended to achieve, though not expressed in the actual language employed.[125]

Although the Australian income tax law contained a wide general antiavoidance and antiabuse provision,[126] consecutive court cases by strict and literal interpretation of the tax law gradually whittled away the scope of that provision.[127] In 1981, the court reversed its stand on literal interpretation and agreed to extend the scope of a statutory provision, although that wider scope was not within the literal meaning of the statute.[128] By that time, however, there had been a political reaction and Parliament had inserted a range of general and specific antiavoidance provisions into the Income Tax Assessment Act, culminating in the adoption in 1981 of a new general antiavoidance rule.[129]

H. United States

Although the Internal Revenue Code contains a limited provision allowing the Commissioner to deny tax benefits from an acquisition, the principal purpose of which is tax avoidance,[130] it does not contain a general provision on interpretation of tax law by the courts. Over time, the courts have developed a doctrine allowing them to set aside certain legal constructions that do

[125]Federal Commissioner of Taxation v. Westraders Proprietary Ltd., 144 C.L.R. 55, 59 (1979–80).

[126]AUS ITAA § 260, which was replaced in 1981 by more comprehensive and at the same time more specific antiabuse legislation. *See infra* sec. III(I).

[127]*See* W.P. Keighery Proprietary Ltd. v. Federal Commissioner of Taxation, 100 C.L.R. 66, 92 *et seq.* (1956–57); Cecil Bros. Proprietary Ltd. v. Federal Commissioner of Taxation, 111 C.L.R. 430, 441 (1962–64); Mullens v. Federal Commissioner of Taxation, 135 C.L.R. 290, 302 (1975–76).

[128]*See* Cooper Brooks (Wollongong) Proprietary Ltd. v. Federal Commissioner of Taxation, 147 C.L.R. 297 (1980–81).

[129]AUS ITAA Part IVA, §§ 177A–G ("Schemes to Reduce Income Tax"). *See infra* text accompanying note 149.

[130]*See* USA IRC § 269.

not have a "business purpose."[131] When a legal construction has as its clear purpose the avoidance of income tax and does not at the same time involve some economic substance, it can be set aside by the courts as having no effect for tax purposes and replaced by another characterization of the underlying factual situation. Starting with the *Gregory* case, the courts have developed several judicial doctrines, such as constructive income or ownership,[132] continuity of business enterprise,[133] and the step-transaction doctrine. The step-transaction doctrine allows a court to decompose a transaction into several distinct steps, or to take several separate transactions together, in order to ascertain whether each of the individual steps, or the overall complex transaction, meets the requirements to benefit from certain effects under the tax law.[134] The precise methods of applying these doctrines are complex and continually evolving.[135]

The issues in applying the substance-over-form approach in U.S. tax case law have been summarized well by Bittker & Eustice:

> One of the persistent problems of income taxation, as in other branches of law, is the extent to which legal consequences should turn on the substance of a transaction rather than on the transaction's form. It is easy to say that substance should control, but, in practice, form usually has some substantive consequences. If two transactions differ in form, they probably are not identical as to substance. Even so, they may be sufficiently similar to warrant identical tax treatment. . . .
>
> The foregoing judicial principles and statutory provisions, which often overlap in practice, are useful deterrents to tax-avoidance schemes of varying scope and ingenuity. Forcing transactions heavily freighted with tax motives to withstand judicial analysis in the context of these broad principles and provisions, vague and uncertain in application though they may be, is more salutary than uncompromising literalism in applying the statutory system for taxing corporations and shareholders.[136]

The often broad way in which U.S. tax courts interpret the tax law should be contrasted with the very close style of legal drafting used in the Internal Revenue Code, which prima facie obliges the courts to make decisions on very

[131]Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

[132]*See* Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 9.02 (6th ed. 1994).

[133]*See* Standard Realization Co. v. Commissioner, 10 T.C. 708 (1948); Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965).

[134]*See* West Coast Marketing Corp. v. Commissioner, 46 T.C. 32 (1966); American Potash & Chemical Co. v. United States, 399 F.2d 194 (U.S. Ct. Cl.), *motion denied*, 402 F.2d 1000 (Ct. Cl. 1968); King Enterprises, Inc. v. United States, 418 F.2d 511 (U.S. Ct. Cl. 1969), *later proceeding* 190 Ct. Cl. 947 (1970).

[135]For a discussion of tests for application of the step-transaction doctrine in reorganizations, *see* McDonald's Restaurant of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1981).

[136]Bittker & Eustice, *supra* note 132, ¶¶ 1.05[2][b], 1.05[3][d] (footnote omitted).

narrow rules. In spite of this, U.S. courts stick to their judicial doctrines, probably because of the common law tradition of legal analysis, where interpreting facts and rules with common sense plays an important role.

I. Antiabuse Legislation

Closely connected with the problems of interpretation of tax laws are statutory measures introduced to provide general rules for the application of tax legislation in situations where taxpayers structure transactions in a peculiar legal form so as to obtain a tax benefit unintended by the tax law. Tax laws being general prescriptions, it is inevitable that the legislator cannot foresee all situations in a rapidly changing world, thereby leaving gaps and loopholes in any tax law.[137] Also, in many cases, the tax law allows the taxpayer a choice between different legal alternatives to reach factual objectives that are identical or very similar, but with different tax consequences. Depending on the legal choice made by the taxpayer, the same factual objective will result in a lower or higher tax burden. The two basically related questions raised here for the application and interpretation of the tax law are (1) what are the respective roles of the legislator and the courts in filling the gaps and loopholes, and (2) should the tax law attach different tax consequences to different legal situations that result in the same or a very similar factual situation?

The answer to these two questions may be clearer if the so-called antiabuse legislation is considered in the wider context of tax evasion and tax avoidance. In practically all developed tax systems, a distinction is made between tax evasion and tax avoidance. Tax evasion or tax fraud[138] is an offense against the tax laws that is punishable by criminal sanctions. It consists of clear violations of the tax laws, such as fabricating false accounts or other documents, keeping parallel accounts, not reporting income, or smuggling or dissimulating goods or assets. The tax consequences of these acts can of course be corrected by the tax administration, but in addition these acts may give rise to criminal sanctions. The statutory measures taken to combat such violations of the tax law are generally not considered to be antiabuse measures.

Tax avoidance, on the other hand, is a behavior by the taxpayer that is aimed at reducing tax liability, but that does not constitute a criminal offense. The distinction between tax avoidance and tax evasion is critical, although sometimes confused, particularly by nonlawyers. Such confusion may be understandable in an economic or moral context, but it is basically wrong in a

[137]Loopholes can also result from a disorderly legislative process. Sometimes chaotic amendments are made at the last minute without an opportunity to consider all their ramifications and make the necessary adjustments.

[138]To avoid any confusion in terminology, it should be noted that "tax evasion" is translated in French as *fraude fiscale* and in German as *Steuerhinterziehung*, whereas "tax avoidance" is respectively translated as *évasion fiscale* and *Steuerumgehung*.

legal context of administration and implementation of tax law. In principle, most countries recognize the right of the taxpayer to arrange his or her affairs in such a way as to pay less tax.[139] The problem is that the lesser tax burden may result from a legal construction or transaction that uses a gap or a loophole in the law to place the taxpayer outside the reach of the tax law or within the reach of a statutory provision providing for a lesser tax burden, or from a legal construction or transaction to which the tax law attaches a lesser tax liability than to another legal construction or transaction with similar factual results. It is clear that on the basis of considerations of economic efficiency (taxing similar economic situations the same way) and of fiscal justice (taxing similar factual situations the same way), there are good reasons to disregard the tax consequences of the legal construction or transaction and to close the gaps and loopholes, subjecting similar situations to the same tax burden. Therefore in some countries some constructions or transactions that constitute tax avoidance, although not a criminal offense, are not recognized for tax purposes either by the courts, or by general or specific antiabuse provisions.

In addition to tax evasion and tax avoidance, there is an activity that can be called tax minimization, which can be defined as behavior that is legally effective in reducing tax liability. It can consist of factual behavior by which taxes are avoided such as not consuming certain products (not smoking tobacco or not drinking alcoholic beverages) subject to tax or not earning certain types of income.[140] This factual avoidance of the tax burden is considered perfectly legal and is not subject to statutory antiavoidance measures. According to Rivier, it consists in "using a lacuna intended by the legislator or the freedom allowed by the law to create a factual situation different from that contemplated by the law, whose consequences for the taxpayer are likewise different from those envisaged by the text of the law."[141] By contrast, tax avoidance typically consists not of factual, but of legal behavior, that is, mold-

[139]For the United Kingdom, Commissioners of Inland Revenue v. Duke of Westminster, 1936 App. Cas. 1, 19 (Lord Tomlin comments, "[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be"); for the United States, Gregory v. Helvering, 69 F.2d 809, 810 (1934)(Judge Learned Hand stating, "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."), *aff'd*, 293 U.S. 465 (1935); for Australia, Jaques v. Federal Commissioner of Taxation, 34 C.L.R. 328, 362 (1924)(Judge Starke wrote, "[t]here is nothing wrong in companies and shareholders entering, if they can, into transactions for the purpose of avoiding, or relieving them of taxation . . ."); for Belgium, Judgment of June 6, 1961, Cour de cassation, 1961 Pas. Bel. I 1082, 1089 ("considering that there is neither a prohibited fabrication with respect to the fisc, nor one which constitutes fraud, when the parties, in order to benefit from a more favorable tax regime, taking advantage of the freedom of contract and without violating any legal obligation, establish legal acts all of the consequences of which they accept, even if the form that they give them is not the most usual one" (ed. trans.)).

[140]Tax minimization is known as *Steuervermeidung* in German and *Belastingbesparing* in Dutch.

[141]Rivier, *supra* note 110, at 60–61 (ed. trans.).

ing factual situations in legal forms that bear less tax than other legal forms. The difficult question is whether a particular instance of such behavior is considered tax avoidance or tax minimization.

The question is whether the refusal to recognize the effectiveness for tax purposes of a legal construction is a task for the legislator or for the courts. The arguments against the courts doing this job are largely based on the principle of legality and the role of the courts vis-à-vis the legislator.[142] The doctrine of the separation of powers holds that it is not for the judiciary to legislate. Therefore, when the clear wording of the tax law fails to tax certain situations, thereby leaving gaps and loopholes, even when reasonably and as a matter of tax policy these situations should be taxed, the courts will shy away from imposing a tax when there is no formal legal basis for doing so. Strangely enough, the same courts may fill the gaps and loopholes left by the legislator in other areas of the law. The reason is that for taxes, many countries have an explicit or implicit constitutional provision limiting the authority to tax in a similar way as the authority to impose criminal penalties: no taxation without legal basis. This supposes for an effective implementation of the tax law an all-knowing and infallible legislator who, in reality, does not exist.

With respect to extending the reach of the tax law to legal constructions and transactions having a factual effect similar to situations subject to a heavier tax, many jurisdictions will allow the tax administration to recharacterize a legal construction or transaction, provided it can show that the legal elements for such different characterization exist, but will refuse a recharacterization for tax purposes when only a similarity in fact exists. In more simple terms, this is stated as the problem of the opposition between substance and form. The attitude of the courts again presupposes that the tax consequences attached to each legal construction or transaction are the adequate tax reply to the factual situation covered by the construction or transaction; that is, it presupposes an infallible inner consistency of the law so that each legal form is always the adequate translation of the underlying substance. That unique quality of the legal rule is of course absent in many cases.

The ways in which the courts of various countries have dealt with these problems have been discussed above.[143] In some countries, the legislator has judged it necessary to take legislative action in the form of general or specific antiabuse provisions to remedy the courts' failure to interpret the law in such a way as to cut off abuse. The general antiabuse provisions, on the one hand, call on the courts to apply an extensive or economic interpretation of the tax law and to disregard legal constructions and transactions when they have an artificial flavor. Specific antiabuse provisions, on the other hand, which can be found in nearly all developed tax systems, are aimed at closing particular gaps and loopholes.

[142]*See supra* sec. III(A).
[143]*See supra* sec. III(A–H).

It should be noted that there is no clear relationship between the way courts interpret tax law (strictly vs. extensively) and the presence or absence of general antiabuse provisions. Several countries operate their tax system without general antiabuse provisions: Belgium (until 1993), Italy, Sweden (1992–95), Switzerland, United Kingdom, and United States. Except for the United States, in most of these countries, tax law is interpreted in a strict or literal way. The combination of case law and specific antiabuse provisions is apparently held to be adequate in administering the tax system. A second group of countries does have general antiabuse clauses in their tax legislation with rather different results. The most prominent examples are Australia, Austria, France, Germany, the Netherlands, and Spain.[144]

The original Australian antiavoidance rule provides that contracts are void for tax purposes if they were made in order to alter the incidence of the income tax, or to defeat, evade, or avoid any liability under the Income Tax Assessment Act.[145] Although the wording of this section was very broad, in the general climate of literal and strict interpretation that was dominating the interpretation of tax law by the Australian courts,[146] the scope of the section was systematically whittled down through the application of the "freedom of choice" doctrine to a narrow rule that became very difficult to apply.[147]

By 1980, it became clear that the existing Australian setup of general and specific antiavoidance clauses and literal or strict court interpretation was not working.[148] In 1981, section 260 was amended to apply only to schemes entered into prior to May 27, 1981, and a whole new set of antiabuse rules applicable to arrangements entered into on or after that date was introduced as Part IVA ("Schemes to Reduce Income Tax").[149] Basically, Part IVA provides that when there is a "scheme" as defined in the statute, the Commissioner has discretionary power to deny a tax benefit or disallow a deduction, which would

[144]Belgium (BEL CIR art. 344, as amended in 1993) and Canada (CAN ITA § 245, introduced in 1988) also have general antiabuse provisions, but they are too recent to be able to evaluate their impact on interpretation of tax laws by the courts. Sweden abolished the general antiavoidance provision in 1992 and reintroduced it in 1995.

[145]*See* AUS ITAA § 260, which became inoperative after May 27, 1981, when the new antiabuse provisions of ITAA Part IVA took effect.

[146]*See supra* sec. III(G).

[147]*See* W.P. Keighery Proprietary Ltd. v. Federal Commissioner of Taxation, 100 C.L.R. 66, 92 (1957)("Whatever difficulties there may be in interpreting s. 260, one thing at least is clear: the section intends only to protect the general provisions of the Act from frustration, and not to deny taxpayers any right of choice between alternatives which the Act itself lays open to them."); Cecil Bros. Proprietary Ltd. v. Federal Commissioner of Taxation, 111 C.L.R. 430, 441 (1964)("Indeed, s. 260 does not authorize the Commissioner to do anything; it avoids as against the Commissioner arrangements, etc. as specified and so leaves him to assess taxable income and tax on the facts as they appear when the avoided arrangements, etc. are disregarded."); Mullens v. Federal Commissioner of Taxation, 135 C.L.R. 290 (1976).

[148]*See* Federal Commissioner of Taxation v. Westraders Proprietary Ltd., 144 C.L.R. 55 (1980).

[149]AUS ITAA §§ 177A–177G.

have been obtained through the scheme, when such scheme satisfies eight conditions set forth in the statute.[150] The crucial question in applying the act is what constitutes a scheme. In section 177A(3) and 177D, a scheme is defined as any unilateral scheme, plan, proposal, action, course of action, or course of conduct entered into or carried out for the purpose of enabling the relevant taxpayer or other taxpayers to obtain a tax benefit in connection with that scheme. Contrary to general antiabuse provisions in Europe and even in Canada, the Australian provision follows a very complicated and technically difficult style of drafting.

The first case involving these provisions to reach the High Court of Australia was *Federal Commissioner of Taxation v. Peabody*.[151] The decision illustrates the complexity of a general antiabuse provision because it had to identify the "tax benefit," "the scheme," and "the relevant or other taxpayer." In this particular case, the taxpayer won on the basis that the Commissioner had allocated the revenue to the wrong taxpayer. The Commissioner also lost the second case brought under this provision on the basis that the dominant purpose of the scheme involved was to make an investment and not to obtain a tax benefit, even though the scheme resulted in earning income that was exempt from tax.[152]

[150]AUS ITAA § 177D provides:

"This Part applies to any scheme . . . where . . . (a) a taxpayer (in this section referred to as the "relevant taxpayer") has obtained . . . a tax benefit in connection with the scheme; and

(b) having regard to—

(i) the manner in which the scheme was entered into or carried out;

(ii) the form and substance of the scheme;

(iii) the time at which the scheme was entered into and the length of the period during which the scheme was carried out;

(iv) the result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

(v) any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

(vi) any change in financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result, from the scheme;

(vii) any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and

(viii) the nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi),

it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person who entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers)."

[151]Federal Commissioner of Taxation v. Peabody, 181 C.L.R. 359 (1994).

[152]*See* Lee Burns & Richard Vann, *Australian Court Considers Source of Interest Income and International Application of the General Anti-Avoidance Provision*, 11 Tax Notes Int'l 1631 (1995).

At the same time that the new general antiabuse provisions were inserted in the Income Tax Assessment Act, Australia amended its Acts Interpretation Act to promote a purposive interpretation of legislation, particularly tax law. The new section reads as follows:

> In the interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether that purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or object.[153]

The combined effect of the changes to the Acts Interpretation Act, the application of the general antiabuse provision of the income tax law, and changes in the composition of the High Court led to a shift from literal to purposive interpretation of income tax legislation.[154]

French tax law contains two general instruments to combat tax avoidance: a provision on the "abuse of tax law"[155] and the court doctrine of the "abnormal management act,"[156] which does not have a direct statutory basis.

The main characteristics of the abuse of tax law provision are that a transaction is subject to sanction only when a specific procedure is followed and, according to the courts, when the transaction has been set up *exclusively* for tax avoidance purposes. This provision covers transactions where the real legal transaction is hidden by an apparent legal transaction (*simulation*),[157] as well as, according to case law,[158] transactions entered into exclusively to obtain a tax benefit (*fraude à la loi*). Because the burden of proof is on the tax administration and the condition of the exclusive tax avoidance motive is difficult to prove, this weapon is seldom used by the tax administration. The French tax administration is now pushing for an amendment to the statute, so as to apply the abuse of law provision in cases where the tax avoidance motive is the dominant reason and not necessarily the exclusive reason for the transaction.

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[153]Acts Interpretation Act, 1901, as amended, 1901 Austl. Acts 2, § 15AA(1). Sec. 15AB of the Act also contains rules with respect to the extrinsic materials that should be taken into consideration for the interpretation of an act. *See infra* ch. 3, sec. III(C) for discussion of Interpretation Acts.

[154]*See* Cooper Brooks (Wollongong) Proprietary Ltd. v. Commissioner on Taxation, 147 C.L.R. 297 (1981).

[155]*See* FRA LPF art. L. 64 to L. 64 B (prohibiting *abus de droit*). This provision was introduced for indirect taxes by an act of July 13, 1925, and for income taxes by an act of Jan. 13, 1941. Act No. 87-502 of July 8, 1987, introduced an optional ruling procedure (known as *rescrit*) for its application.

[156]*Acte de gestion anormale*.

[157]*See* FRA LPF art. L. 64 (stating "les actes qui dissimulent la portée véritable d'un contrat ou d'une convention . . .").

[158]Judgment of June 10, 1981, No. 19,079, Conseil d'Etat, Lebon 248; Judgment of Apr. 19, 1988, No. 86.19079, Cour de cassation, Chambre commerciale, Revue de jurisprudence fiscale 1989, No. 2, at 47. *See also* Cyrille David et al., Les grands arrêts de la jurisprudence fiscale, *Thème* 9, 106 *et seq.* (2d ed. 1991).

The abnormal management act doctrine has no specific statutory basis, but has been entirely developed by the courts.[159] It is based on the theory that a business taxpayer cannot engage in any activity that is contrary to the taxpayer's business interest because the purpose of the business is to make a profit. This does not mean that the taxpayer has the obligation to maximize business income under all circumstances, but it allows the tax administration to intervene in situations in which the taxpayer reduces taxable income, by acts against the taxpayer's business interests, in order to transfer income to another taxpayer who is exempt or who is taxed at a lower rate. Because the burden of proof is less onerous than under the abuse of tax law provision and because there is no specific procedure, the tax administration prefers this court doctrine to combat abuses of taxpayers.[160] The application of the abnormal management act doctrine is not subject to any special procedure. In most cases, it presents problems of fact and not of law, so that it is to be distinguished from the abuse of tax law provision of the code of tax procedure. However, the same transaction can reduce a taxpayer's income by an act against the taxpayer's business interests, while at the same time having been entered into exclusively for tax avoidance purposes. In such a case, both antiabuse instruments would be applicable.

Germany introduced quite early[161] a provision in its general tax laws obliging the courts to follow the economic interpretation of the tax law.[162] Gradually, however, the Court of Tax Appeals shifted its interpretation to a more traditional stance, giving predominance to concepts of civil law over tax concepts, so that the taxpayer would be in a position to make a choice between different legal forms of a transaction to minimize the taxpayer's tax burden.[163] Also, in the German tax doctrine, the economic interpretation was not considered specific for tax law, but was a general kind of teleological interpretation.[164] When the new General Tax Law was introduced in 1977, the mandatory economic interpretation method of tax laws was abandoned and replaced by several antiabuse provisions.[165]

The new provisions are contained in DEU AO sections 40 through 42, of which section 42 is the most important for the interpretation of tax law. AO section 40 establishes the rule that transactions will be taxed whether they are legal or not. The effect of this section is to tax profits from illegal activities,

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[159]*See* Judgment of Apr. 14, 1976, Conseil d'Etat, 1976 Lebon, No. 97.260, at 202; Judgment of Apr. 30, 1980, Conseil d'Etat, 1980 Lebon, No. 16.253, at 206.

[160]*See* commentary and cases cited in David et al., *supra* note 158, at 328 *et seq.*

[161]*See* Reichsabgabenordnung of 1919 § 4; Steueranpassungsgesetz of 1934 § I/II.

[162]*Die wirtschaftliche Betrachtungsweise. See supra* discussion on court interpretation in Germany, sec. III(D).

[163]*See* Decision of Bundesfinanzhof, 1967 Bundessteuerblatt II 781, 782.

[164]*See* 3 Tipke, *supra* note 53, at 1289.

[165]Austrian law still requires the true economic content of a transaction to be given effect in precedence to its outward appearance. *See* AUT BAO § 21.

like gambling, drug trafficking, and so on, so as to avoid a situation in which illegal activities would benefit from a tax exemption.[166] It is important to note that deductions for expenses are also allowed, even when incurring such expenses would constitute an illegal activity.[167] AO section 41 subjects to taxation transactions that are legally invalid for nontax purposes under civil or commercial law when the economic substance of the transaction is maintained in spite of its legal nullity. It also disregards sham transactions.[168] A sham transaction exists when the parties agree that the transaction should have no legal effect or when one legal transaction is used to hide another legal transaction. Both sections base taxation on the economic or, more generally, the factual substance of a transaction, without regard to its illegality, nullity, or legally fictitious character. In this sense, both sections can be considered a continuance of the economic application of tax law.

The most important general antiabuse clause is contained in AO section 42, providing that tax cannot be avoided by "abuse of legal constructions."[169] When abuse of a legal construction is established, the tax claim will be based on the legal form of the transaction that is appropriate to the legal factual situation. An abuse is considered to exist when the legal form of the transaction or construction used by the taxpayer is not appropriate to the factual *economic* situation. The key word in this provision is "appropriate."[170] It requires that the factual consequences of a transaction be more or less consistent with its legal form. The abuse consists of the choice of a legal form that is inappropriate for the economic relationship in order to avoid taxes.[171] The legal form of a transaction will be considered inappropriate when reasonable persons—in order to achieve a specific economic relationship and, in particular, a specific economic goal—would not choose a particular legal form because they would consider it inadequate.[172] The specific characteristic of the German law is that it requires some consistency between the legal form and the economic content of a transaction. In many other tax systems, it suffices to have a business purpose, even if the legal form in which this business purpose is achieved is not entirely appropriate. If a transaction has no business purpose at all, it may be assumed that the legal form is inappropriate and that there is abuse of a legal construction. Generally speaking, for a legal transaction to be effective for tax purposes, it will require (1) a business purpose, and (2) an adequate legal form to achieve the business objectives of the taxpayer. It is clear that when there are several adequate legal forms to achieve these business objectives, the sec-

[166]In some countries, this rule has been established through case law. *E.g.*, James v. United States, 366 U.S. 213 (1961).

[167]*See* 3 Tipke, *supra* note 53, at 1322–23.

[168]*Scheingeschäfte or Scheinhandlungen*.

[169]DEU AO § 42 (ed. trans.).

[170]*Angemessen*.

[171]3 Tipke, *supra* note 53, at 1336.

[172]*Id.* at 1337.

tion will not be applicable when the taxpayer chooses the legal form that minimizes the taxpayer's tax burden.

In the Netherlands, a general antiabuse provision was introduced in the General Tax Law in 1925. Since 1959, it provides that a legal transaction that does not have as its purpose a significant change in the factual circumstances or that would not have occurred but for the fact that it eliminates or reduces the tax liability shall not be taken into account; that is, when the exclusive purpose of a transaction is to minimize the tax burden, it is subject to correction for tax purposes.[173] In the Dutch tax literature, this provision is known as "correct taxation."[174] The tax inspector who wants to apply the procedure of correct taxation has to ask for specific advance approval from the Minister of Finance. Given the judicial development of the *fraus legis* doctrine, the statutory provision has been of limited importance.[175]

In Spain, the abuse of law doctrine is based on article 6.4 of the Civil Code, which was adopted in 1974.[176] This concept of civil law was also used for tax purposes, because although the General Tax Law referred in article 24, paragraph 2 to "abuse of law,"[177] there was no clear definition of abuse of law in the tax code.[178] In 1979, this provision was implemented by a decree establishing a special procedure for the application of the concept of abuse of law.[179] As in France, this procedure is to be followed when a taxpayer is notified that the taxpayer is accused of abuse of law. The burden of proof is with the tax administration. In addition, article 25 of the Spanish tax code provides that taxes should be levied in accordance with the real legal or economic nature of the taxable event.[180] When the taxable event consists of a legal transaction, it will be characterized for tax purposes in accordance with its "true legal nature," regardless of the form of the transaction. When the taxable event is determined

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[173]*See* NLD AWR art. 31.

[174]*Richtige heffing*. *See*, for a more ample report, A. Nooteboom, *Netherlands*, LXVIIIa Cahiers de droit fiscal international 545 (1983).

[175]*See supra* sec. III(E).

[176]Código Civil art. 6, ¶ 4 (ESP)(stating "acts concluded within the scope of the text of a rule which pursue a result prohibited by the legal regulation or contrary to it, shall be considered as executed as a fraud on the law and shall not thwart the proper application of the norm that was sought to be avoided" (ed. trans.)).

[177]ESP LGT art. 24, ¶ 2 (providing, in part, "to avoid fraud on the law it will be understood, for purposes of the previous paragraph, that there is not an extension of the taxable event in the case of taxation of actions realized for the proven purpose of evading the tax, as long as they produce a result equivalent to that derived from the taxable event" (ed. trans.)).

[178]For a full discussion of the abuse of law provisions in Spain, *see* Escuela de Inspección Financiera y Tributaria, Ministerio de Economía y Hacienda, Compendio de Derecho Tributario Español 79–88 (4th ed. 1984).

[179]Real Decreto [Royal Decree] 1.919/1979 of June 29, 1979, por el que se regula el procedimiento especial de declaración de fraude de Ley en materia tributaria, Boletín Oficial del Estado de 6 de agosto.

[180]*See* ESP LGT art. 25, ¶ 1 (providing "[e]l impuesto se exigirá con arreglo a la verdadera naturaleza jurídica o económica del hecho imponible").

by economic concepts, it will be characterized in accordance with "effective economic relationships." Both provisions seem to indicate a strong bias in favor of economic interpretation of tax law and of substance over legal form.

However, article 24-1 of the General Tax Law contains an explicit prohibition of extensive interpretation of tax law and interpretation by analogy beyond the strict meaning of the words. The resulting legal framework of the antiabuse provisions in Spain is at least confusing, and there is great debate about the exact meaning of the provisions. As a result, these contradictory legal prescriptions have driven the High Court to very divergent applications of tax laws.[181] Recently, article 24 on abuse of law has been amended.[182] Under the amended language, reference to economic or social interpretation has been eliminated. Taxes will be due on the basis of the "legal nature" of the taxable event. The new Spanish law establishes the "legal reality" of transactions as the sole legal basis for taxation, as opposed to economic or social reality.

J. Specific Antiabuse Provisions

In addition to general antiabuse rules, the tax laws of most countries contain specific antiabuse provisions.[183] The approach of the specific provisions is different from the general antiabuse provisions, because in many cases they do not focus on application or interpretation of tax law, but simply mechanically deny certain tax benefits under certain conditions. Their goal is to prevent avoidance or abuse of specific rules in the tax code. It is impossible to make an inventory of all the rules that vary from country to country; some examples are listed below.

Most countries have the following antiavoidance rules in the domestic area: (1) limitation of deductions for entertainment and traveling expenses; (2) rules on taxation of accrued as opposed to effectively paid interest; (3) rules on arm's-length dealing between related taxpayers, or between taxable and tax-exempt taxpayers; (4) rules against dividend stripping; (5) limitations on tax loss carryovers from one taxpayer to another; and (6) limitations on loss deductions by partners and shareholders in companies not subject to corporate income tax.

In the international context, the following rules are common: (1) rules on dealing at arm's length in international transactions; (2) rules on thin capitalization; (3) rules against the transfer abroad of income-generating assets without payment of tax; (4) rules on controlled foreign corporations; (5) rules limiting the effects of physical emigration of taxpayers; (6) rules limiting tax benefits for

[181]*See* Judgment of Apr. 5, 1982, Repertorio de Jurisprudencia 1982, No. 1972; Judgment of Mar. 5, 1988, R.J. No. 1649; Judgment of May 3, 1988, R.J. 1988, No. 3763.

[182]*See* Law of July 20, 1995; ESP LGT arts. 24, 25, 28.2.

[183]A full discussion of these rules can be found in the relevant chapters of the material tax law throughout the book. Provisions of an intermediate nature are also possible, for example, a denial of deductions incurred in a contract lacking a real economic purpose. *See* Daniel Deak, *New Anti-Avoidance Legislation Enacted in Hungary*, 12 Tax Notes Int'l 446 (1996).

income sourced in tax havens; and (7) rules limiting deductions of expenses and losses in corporate headquarters or branches of foreign companies.

K. Conclusion

This brief survey shows that the problems of tax avoidance and the issues of substance over form are truly universal, although there are variations in each tax system. Basically, there have been two broad alternative legislative and judicial approaches in the countries surveyed. Courts have interpreted tax laws either in a strict and literal way or in a more flexible way that takes into account the economic and social objectives of the tax laws. The way in which courts interpret tax laws will of course depend on the way courts interpret laws in general and on whether over time they have developed special doctrines for the interpretation of tax laws. Because of limits to what courts can or are willing to do to combat tax avoidance by interpreting the tax laws, many legislatures have resorted to the enactment of antiavoidance provisions.

The survey of the general antiabuse and antiavoidance provisions shows that they are a mixed blessing. The best and most consistent results seem to have been achieved in countries that do have a general antiabuse provision on the statute books, but one that is very sparsely used by the tax administration, because the courts have developed a reasonable—and not too strict or literal—approach to the interpretation of tax law.[184] Very close is the situation in which there is no general antiabuse provision, but in which the courts have developed a general antiabuse doctrine, like the business purpose test.[185] A second-best solution provides for a general antiabuse provision on the statute books, which is sometimes used by the tax administration under strict and narrow conditions imposed by law.[186] In Spain, however, there was the problem of the contradiction between the statutory provision on narrow interpretation of tax law and the general antiabuse provision, which has recently been addressed by legislation introducing the concept of the legal nature of the transaction.[187] The worst scenario, apparently, is the historic Australian experience in which frequent reliance by the tax administration on a general antiabuse provision is combined with strict and literal interpretation of tax law by the courts.

These experiences suggest that for countries that do not have a long court tradition, a general antiabuse provision should be combined with intense education of judges on how to develop legal reasoning and on how to make a reasonable application of the rule of law in general and the rule of tax law in particular. For countries that do have a long court tradition, the solution is simpler: when court interpretation is flexible, no general antiabuse provisions are needed; how-

[184] *E.g.*, Germany, the Netherlands. *See supra* secs. III(D), (E), (I).
[185] *E.g.*, United States. *See supra* sec. III(H).
[186] *E.g.*, France, Spain. *See supra* sec. III(I).
[187] *See supra* note 180.

ever, when court interpretation is strict, it may be preferable to work on the education of judges rather than to introduce a general antiabuse provision.

Finally, an increase in aggressive tax planning and resulting tax avoidance have been caused in part by the increasing complication of tax laws and by the growing burden of taxation. This is an imperative reason for drafting simple tax laws, leaving few options to the taxpayer and reducing to an absolute minimum the possibilities for tax arbitrage between the various options. In the end, the justice of a tax system is better served by simple rules that do not make too many distinctions, but that can be applied effectively, than by rules that try to take into account the very different relative positions of various taxpayers, but that can be avoided by taxpayers rich enough to pay for good tax advice.

IV. Distribution of Tax Law Making Power Between the Legislative and Executive Branches of Government

One of the most perplexing problems that tax officials in developing and transition countries face is in determining the proper role for executive rules to interpret and implement tax laws. It is clear that the legislature is responsible for passing the law, but what is the proper scope for administrative interpretation? Additional questions arise regarding the level of detail to be provided; the type of document to be issued; the name to be given to the document; the organization to issue the document (tax administration, minister of finance, cabinet); the effective date, time, and party to issue the document; and the legal effect to be given to the executive rule.

These questions can be difficult to answer because there are substantial differences in practices from country to country. Moreover, the basic rules governing the legality of permitted practice are often elastic. The legal effect to be assigned to a particular type of executive rule depends on the country's general constitutional and administrative law, doctrines of legislative interpretation developed by courts or enacted in law, and specific provisions in tax laws that may prescribe the legal effect of particular types of administrative acts.

Not only is there considerable variation on these matters from country to country, but even within the legal tradition of a particular country, it may be difficult to determine the legal effect that courts give to administrative pronouncements. This is because standards for statutory interpretation and the scope of judicial review of administrative action are often quite elusive. Even when courts can agree on general principles, the application of those principles to particular cases can be controversial.

A. Distinction Between Executive and Legislative Functions of Government

Democracies generally subscribe to the doctrine of the separation of powers, according to which there are three independent branches of government:

the legislative, the executive, and the judicial.[188] Under the general distinction between the legislative and the executive functions of government, lawmaking, in the sense of establishing the general rules that control behavior in the society, is the privilege of the legislative branch (parliament), while the implementation and the administration of the laws pertain to the executive branch. In many countries, the power of the executive branch to implement the laws by government ordinance or decree is based on a general delegation of power in the constitution to implement any law approved by parliament.[189] In other countries, the delegation of power must be specifically provided for in the law or is limited in the constitution itself.[190] As an exception to this principle, some constitutions assign to the executive branch the power to make law by decree without the consent of parliament, usually strictly limiting this power in scope or in time or permitting it only when a state of emergency or specific authorization by the legislature exists.[191]

The distinction between lawmaking and administration is not always clear-cut, because administration necessarily involves an element of discretion in interpreting the law. In addition, the administrative branch may be authorized to issue norms with greater or lesser legally binding force in order to carry out the law.

Administrative acts with the greatest legal force are referred to as regulations. (They may also be referred to as orders, decrees, rules, or ordinances.) The relevant minister or the cabinet of ministers may be authorized directly under the constitution to issue regulations to carry out the laws, or tax laws may delegate authority to issue regulations. As long as a regulation is not contrary to the statute, it has the force of law, which means that it is binding on both the taxpayer and the state. Regulations are typically used to fill in gaps and details that are not dealt with in the statute, although they may also fashion rules out of whole cloth when so authorized.

The division of responsibility between laws and regulations varies greatly from country to country, because traditions of administrative law differ among countries. It is therefore important to design tax laws to fit within the country's scheme of administrative law. In some countries, very short statutes and detailed regulations are routinely written;[192] in other countries, the constitution

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[188]*See* Charles-Louis Montesquieu, De l'esprit des lois 142 (Garnier Frères 1869); John Locke, Of Civil Government, Book II, 190–92 (1924).

[189]*E.g.*, Grondwet [constitution] art. 108 (BEL); Const. art. 37 (FRA); Grondwet [constitution] art. 89 (NLD); Const. art. 201 (PRT).

[190]*E.g.*, GG art. 80 (DEU); Grundloven [constitution] art. 17 (NOR); Const. art. 82 (ESP); Regeringsformen [constitution], ch. 8, arts. 7–12 (SWE).

[191]*See, e.g.*, Const. arts. 38, 92 (FRA). The French Constitution also provides in art. 37 for a general power to make regulations on matters that are not within the scope of lawmaking under art. 34. This means that regulations can be made by the executive under art. 37 without the explicit delegation of authority by a law. *See also* Grundlov [constitution] § 23 (DNK); Const. art. 86 (ESP).

[192]For example, the former Soviet Union. *See* Butler, *supra* note 188, at 44–45.

may leave a very narrow scope for regulations, thereby requiring all necessary details to be put into the statute.[193]

B. Delegation of Power to Make Tax Laws in the Continental European Tradition

In the European continental tradition, the executive branch has the power to establish rules for the implementation or administration of tax laws by way of regulation, provided that the statute approved by parliament contains sufficiently specific rules defining the essential elements of the tax.[194] This means that the act of parliament must contain the rules defining the taxpayer, taxable events, tax base, tax rates, and rules for the collection of tax.[195] This power of the executive branch of government to execute or implement the tax laws is based on a general or specific delegation of power in the constitution. Tax regulations issued under such delegation of power are limited to the implementation of the law itself and are valid only within the limits of those laws. What can be determined by executive decree are matters of detail, procedure, and administra-

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[193]The Constitution of Guatemala prohibits tax regulations from modifying the statutory liability to pay tax and confines them to procedural issues. Art. 239 provides:

> The provisions, hierarchically inferior to the law, which contradict or twist the sense of the legal provisions regulating the bases of tax collection, are 'ipso jure' void. Regulatory provisions cannot modify said bases and will provide specific rules for the administrative collection of taxes and establish the procedures facilitating their collection.

[194]For example, under art. 34 of the French Constitution, "the basis, the rate and the methods of collecting taxes of all types" must be determined by an act of Parliament. *See* VII Constitutions of the Countries of the World (Albert P. Blaustein & Gisbert H. Flanz eds., 1988). Art. 37 provides that "[m]atters other than those that fall within the domain of law shall be of a regulatory character." *Id.* Accordingly, matters such as administration and procedure may be dealt with by regulation. *See* Loïc Philip, Droit fiscal constitutionnel 29 (1990). Moreover, while a strict reading of art. 34 would require all rules concerning the basis, rate, and methods of collecting taxes to be enacted by Parliament, leaving no room for regulations, given the impracticality of such an approach, the French courts have recognized that while the basic rules of taxation must be contained in the law, regulations may provide for the application of these rules. *See id.* at 30; *see also* Judgment No. 86-223 of Dec. 29, 1986, Con. const., 1987 J.C.P. II, No. 20903. On the limitations of tax law making powers, *see* Judgment of Oct. 12, 1983, Con. const., 1985 Recueil Dalloz-Sirey, Jurisprudence, Informations rapides 351; Judgment of May 23, 1984, Conseil d'Etat, 1984 Lebon 188. Thus, while in principle there is a constitutional limitation on what may be provided in regulations, as opposed to laws, as a matter of practice, many rules of taxation are provided by regulation. The Code général des impôts (CGI) does not specifically authorize regulations, since this is unnecessary under the constitutional system. The French regulations are published in a companion volume to the CGI and are about equal in length to the Code.

[195]*See* GG art. 80 (DEU). On the basis of this constitutional provision, a regulation (*Durchführungsverordnung*) has been issued for practically all the major taxes. *See also* Judgment of Mar. 5, 1958, BVerfG, 7 BVerfGE, No. 36, at 282, 301 (DEU)("Art. 80 of the Constitution is intended to force the legislator itself to set the rules that are decisive for the regulation of an area, and to the extent that details are left to the executive, to determine their direction and extent, in such a way that the possible contents of the regulations can be foreseen" (ed. trans.)).

tion.[196] A regulation that extended the scope of the tax law, changed its conditions, or altered the meaning of the law would have to be declared illegal and inapplicable by the courts.[197] The tax administration will be bound by the regulations issued by the executive branch, as long as they have not been declared illegal by a court. In many cases, there will be specific delegation of powers in the tax law, but such specific delegation of power does not add anything to the delegated power of the executive branch of government if a general or specific delegation of such power already exists in the constitution.

In exceptional and very limited circumstances, the legislator may give a full delegation of power to the executive branch to establish tax laws or essential elements of tax laws by decree. Such delegation of power may be specifically provided for in the constitution[198] or in the constitutional doctrine.[199] In such cases, the law containing the delegation often requires post factum ratification of the decree by an act of parliament.[200]

C. Delegation of Tax Law Making Powers in Common Law Countries

The power of administrative agencies to make law is viewed somewhat differently in common law countries such as the United States, the United Kingdom, and Canada. Unlike in continental Europe, there is generally no constitutional delegation of tax law making power to the executive branch of government. Rather, such delegation is by statute. For example, in the United States, the Treasury Department issues tax regulations, in conformity with general provisions of administrative law (embodied in part in the Administrative Procedure Act),[201] and under the explicit general delegation of authority in the IRC to issue regulations implementing the tax laws.[202] In addition, spe-

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[196]For instance, the models of tax forms to be filed and the annexes to be joined, the tax rules that are specific to a certain industry in applying a tax, schedules for depreciation and stock valuation, rules specifying evidence for certain business expenses, specific accounting requirements for tax purposes, implementing rules for tax registration, and rules containing filing requirements.

[197]*E.g.*, Sentencia de la Sección Cuarta, Sala de lo Contencioso Administrativo del Consejo de Estado (Aug. 26, 1994)(COL)(finding a decree invalid because it contradicted the statute).

[198]*See* Grundlov [constitution] § 23 (DNK); Const. arts. 36, 38 (FRA); Const. art. 86 (ESP).

[199]This is the case in Belgium, where the Constitution does not provide specific delegation of powers in tax matters.

[200]A case in point is the determination of VAT rates in Belgium. VAT rates can be determined by government decree, provided that at the end of the calendar year, the decree is ratified by Parliament.

[201]5 U.S.C. § 551 *et seq.* (USA).

[202]Section 7805(a) of the U.S. Internal Revenue Code provides that "the Secretary shall prescribe all needful rules and regulations for the enforcement of this title. . . ." The authority for Canadian Income Tax Regulations follows basically the same pattern as that of the United States. Section 221(1)(j) of the Canadian Income Tax Act (CAN ITA) gives broad powers to make regulations "generally to carry out the purposes and the provisions of the Act." However, regulations that are inconsistent with the provisions of the Act will not be applied by the courts. *See* Charos v. Minister of National Revenue, 62 Dominion Tax Cases [D.T.C.] 273 (1962). Regulations are published in the Canada Gazette. CAN ITA § 221(2).

cific provisions of the IRC grant authority to issue regulations. For example, IRC section 7872 grants the Treasury Secretary authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section." In allowing regulations to carry out the *purposes* of the section, this language is broader than the general language in section 7805. However, the specific delegation of regulations authority is confusing, because it is either superfluous or casts doubt on the general delegation of authority in section 7805.

Under the Administrative Procedure Act, regulations are divided into interpretive and legislative regulations, although the distinction between them is not always clear. IRC section 7805 provides sufficient authority for the Secretary of the Treasury to issue regulations interpreting the provisions of the IRC. These will be upheld as valid by a court if they are not inconsistent with the statute. Under broader grants of authority to issue legislative regulations, the regulations may set forth rules that go beyond interpreting the statute. An example is IRC section 385, which authorizes regulations distinguishing between stock and indebtedness, requiring only that the Secretary take certain factors into account. Therefore, as long as statutory authority for a regulation exists, U.S. administrative law does contemplate lawmaking by an administrative agency within the framework of a statute.

The U.S. tax regulations are the most voluminous in the world. Fortunately for those who must consult them, they are numbered according to the sections of the Internal Revenue Code to which they correspond. For example, Treasury Regulation Section 1.117-1 is the first regulations section corresponding to IRC section 117; section 1.117-2 is the second section, and so forth. Most sections are quite lengthy and are subdivided according to a system similar to that used to subdivide sections of the U.S. Code.

Similarly, in the United Kingdom, the executive branch may issue such delegated legislation as it is authorized to do by act of Parliament.[203] The power to make laws is vested in Parliament. However, nothing prevents Parliament from delegating this power, in other words, authorizing governmental bodies to make law by administrative order and even to amend acts of Parliament if so authorized.[204] Delegated legislation must be within the scope of the delegated power; otherwise, it can be struck down by the courts.[205] There is no single name in the United Kingdom for delegated legislation (e.g., regulations, rules, orders), although they are published in a uniform series of statutory instruments.[206] In the tax area, there are voluminous regulations, although their text is not as long as that of the laws themselves (about 1½ volumes of statutory instruments to 3½ volumes of laws). This is partly due to the extensive use of schedules to the laws, which often contain what would otherwise be in reg-

[203]*See generally* H.W.R. Wade, Administrative Law 733–47 (5th ed. 1982).

[204]*See id.* at 738–39.

[205]*See id.* at 748.

[206]*See id.* at 735–36, 741.

ulations. In contrast to the tax regulations of the United States, which are arranged according to the arrangement of sections of the statute, the various U.K. regulations stand alone, which obscures their relation to the statute.

D. Administrative Commentaries, Interpretations, and Statements of Practice

In addition to executive decrees and regulations, most tax administrations in continental European countries issue administrative commentaries, instructions (which may relate to specific tax forms or be published separately), guidance to their own staff, and circular letters.[207] Such administrative commentaries or instructions are binding only on the administration for which they are intended. They are not binding on the taxpayers or the courts. There are several cases in which the courts have specifically rejected the interpretation of the tax law made by the tax administration in such administrative commentaries or instructions.[208]

The U.K. Inland Revenue issues "statements of revenue practice." These are of great importance for the practical administration of the tax system, although they do not have the force of law. Statements of revenue practice generally are interpretations of the tax law by the tax administration. They also include "extra-statutory concessions." These are written almost in legislative form, although they do not have the same formal status as a statute in the sense that the tax administration does not have a binding obligation to apply them. However, development of administrative case law suggests that the Inland Revenue would not be authorized to deny such a concession to a taxpayer, because such a denial would constitute a breach of duty to act fairly between different taxpayers.[209] The ostensible purpose of these concessions is to deal with hardships that are minor or transitory, although in fact they can be more significant.

Revenue Canada issues interpretation bulletins stating its views on how to interpret and apply particular provisions of the tax laws. These administrative bulletins have no legal force, but Revenue Canada, in most cases, follows its own interpretation bulletins. Thus, if a taxpayer also follows them, the tax authorities cannot challenge the taxpayer's position. If a taxpayer disagrees, the taxpayer can challenge the position of the tax authorities in court.

[207]*E.g.*, *Verwaltungsanordnungen* in Germany. In France, the tax administration publishes instructions and circular letters; these are binding on it. It also publishes annually an explanatory treatise, the *Précis de fiscalité*; unlike administrative commentaries and interpretations in circular letters or instructions, the *Précis de fiscalité* is not binding on the French tax administration.

[208]For Belgium, Judgment of Nov. 22, 1949, Cour de cassation, 1950 Pas. Bel. I 182, 1949–50 Algemeen Fiscaal Tijdschrift 258; for Canada, Stickel v. Minister of National Revenue, 72 D.T.C. 6178 (1972) and Canadian Pacific Ltd. v. the Queen, 76 D.T.C. 6120 (1976); for Germany, Judgment of May 31, 1988, BVerfG, 78 BVerfGE, No. 20, at 214, 227; for Spain, Escuela de Inspección Financiera y Tributaria, *supra* note 178, at 57.

[209]*See* Butterworths U.K. Tax Guide 1990–91, ¶ 1:33 (John Tiley ed., 9th ed. 1990).

In the United States, the Internal Revenue Service issues a steady stream of revenue rulings, instructions, and other releases on how it believes the tax laws should be applied. These administrative pronouncements are not binding on the taxpayer, but, until they are withdrawn, they are binding on the lower tax officials.

E. Administrative Rulings

Administrative rulings are an important instrument in the implementation of tax law.[210] Some countries, like Australia, Canada, the Netherlands, the United Kingdom, and the United States, have a long tradition of advance rulings. This means that the tax administration will issue a binding application of the tax law to the facts presented by the taxpayer on the condition that the taxpayer give a full and fair representation of all the relevant facts. Such rulings are effective in avoiding conflict and litigation by establishing in advance an authoritative interpretation of the tax law, so that the taxpayer has full security in the way the tax law will work out in a specific situation.

In allowing the tax administration to issue rulings, the following basic questions should be kept in mind: (1) Is the effect of the ruling limited to the taxpayer who requested the ruling, or can other taxpayers also rely on the ruling? (2) Is the ruling regularly published or not? (3) Are there public and private rulings? (4) Which administrative ranks of tax officials have authority to issue a ruling? (5) Are ruling decisions decentralized at the local level or are they centralized at a higher level or issued by a special unit of the tax administration? (6) What is the exact procedure for requesting a ruling and for deciding on and issuing a ruling? (7) What are the conditions under which the tax administration can change its position under a ruling?

In some countries, like the Netherlands, the power of the tax administration goes even further in that the tax inspector can grant a private ruling for a taxpayer by which he or she grants certain concessions. This type of ruling gives enormous flexibility to the application of tax law and permits the establishment of private tax concessions that are not published by way of general rule. Such power can be granted only to tax officials who show great restraint and discipline and are immune from corruption.

In other countries, however, the tax administration cannot issue binding advance rulings. The absence of the power to grant advance rulings has to do with a general view of the role of the tax administration and the role of the tax law and is closely linked to the principle of legality of the tax law and public order, according to which the tax law must be applied strictly and no agreements can be made on its application.[211]

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[210]*See, generally*, International Fiscal Association, Advance Rulings: Practice and Legality (1994); Jason Chang et al., *Private Income Tax Rulings: A Comparative Study*, 10 Tax Notes Int'l 738 (1995).

[211]*See supra* note 14; Rivier, *supra* note 110, at 302.

Sweden has a unique system for advance rulings, whereby these are issued not by the tax administration but by an independent council.[212] Decisions of the council can be appealed. "After more than 40 years of Swedish experience with advance rulings, it is quite clear that the cases of advanced rulings being appealed against to the Supreme Administrative Court have delivered an extremely important part of our case law, perhaps the majority of leading cases, and proven of particular value in making court testing, especially of new legislation, possible early enough as to be of real guidance from the outset."[213]

France has a specific system of preliminary agreement, which should be distinguished from the ruling system.[214] It makes certain tax benefits dependent upon the preliminary fulfillment of certain conditions that are reviewed by an agency other than the tax administration. These preliminary agreements can be found, for instance, with tax benefits granted within the framework of economic development of the regions or the economic restructuring of certain industries. The conditions of economic development or restructuring realized by the taxpayer will be evaluated to see whether the taxpayer meets the requirements for the tax benefit.

Finally, specified tax treatment of a transaction may be conditional upon preliminary approval by the tax administration.[215] Such a preliminary approval is often used to guarantee that the taxpayer will not abuse the transaction for purposes of tax evasion or tax avoidance. A requirement of preliminary approval may be particularly appropriate for types of transactions that are rare and that, in the absence of an approval requirement, would need complex statutory provisions. In a certain sense, this is a mandatory preliminary ruling. In particular, tax administrations that are not strongly equipped may be tempted to exercise this type of control on taxpayers. However, precisely because such preliminary agreements are often used by weak tax administrations, they can result in corruption and should therefore be implemented only with caution.

V. Division of Tax Powers Between the Central and Local Governments

The allocation of fiscal powers between different levels of government is a complex problem meriting a whole book. Here, a brief overview of the main legal issues is provided.

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[213]Leif Mutén, communication to editor (1995).

[214]*See* Gambier & Mercier, *supra* note 45, at §§ 2260–70 (*les agréments fiscaux*). A similar procedure is applicable in the United States with respect to certain tax benefits, for example, the historic rehabilitation tax credit, which is based on approval of a project by the Interior Department. *See* USA IRC §47(c)(2)(C).

[215]*See, e.g.*, USA IRC § 367(a)(1981) (transfer to foreign corporation is taxable event unless the Secretary issues a ruling pursuant to a ruling request filed within 183 days after the beginning of the transfer). In 1984, the requirement to obtain a ruling was repealed.

A. Classification of Tax Powers

Tax law making powers can be divided in different ways. First, a distinction can be made between various types of taxes: income taxes, wealth taxes, turnover taxes, excise and consumption taxes, and so on. The power of taxation with respect to one particular category of tax is often fully reserved for one specific level of government.

A second distinction can be made with respect to the basic elements of any tax. The structure of any tax consists of several elements: the subjects of the tax or the type of taxpayers, the tax base, the tax rate, and the tax procedure. Theoretically, it is possible to reserve the power to legislate with respect to one element of taxation for one level of government (e.g., tax base and rate) and another element for another level of government (e.g., tax procedure).

Finally, a distinction can be made between the levels of implementation of a tax. As explained above, legislative power can be reserved for one branch of government, while administrative implementation is reserved for another. This is a traditional distinction that can be made for any type of lawmaking power. However, the distinction between lawmaking power and administrative implementation may also be made between different levels of government (e.g., central and regional or local government). In such a case, it is necessary to specify which level of government exercises general lawmaking power, and which levels of government exercise various administrative powers of implementation at various hierarchical ranks—for example, executive decrees, regulations, rulings, and instructions.

B. Leading Principles in the Distribution of Tax Powers

1. *Federal vs. a Centralized State*

The most important factor that determines the distribution of tax law making powers among the various levels of government is whether the state is federal or centralized. In referring to federal and centralized states, it is important to remember that these are simplifications and that the constitutional reality of any particular country may defy easy categorization.

In a centralized state, there are usually only two significant levels of government: the central government and the local government. Intermediate levels of government can exist, but they are usually politically and fiscally unimportant. A federal state is characterized by the fact that in addition to the central and local levels of government, there is a strong intermediate level of government in the form of autonomous or independent regions or states. In several European countries, there is a tendency toward the constitution of a federal state. Formerly centralized states, such as Belgium, France, Italy, Spain, and even the United Kingdom, are all in varying degrees in the process of organizing political and fiscal power at the intermediate level of government. For

example, Belgium and Spain have become federal states similar to Austria and Germany. Yet, examples of fairly centralized states continue to exist—Denmark, Ireland, Netherlands, Portugal, and Sweden.

2. *Economic and Monetary Union in a Federal State*

Within a federal state with a market economy, the preservation of economic and monetary union is a basic element in determining at what level of government certain taxes should be levied.

An economic and monetary union in a free market presupposes a minimum degree of economic cohesion and uniformity. This in turn requires that certain taxes be levied only by the central government. An obvious example is customs duty. If regional governments have the power to levy customs duties, they can obstruct the flow of goods between regions. The first rule of an economic and monetary union is that all taxes related to the import or export of goods are levied by a central authority or at least levied in accordance with rules that are the same for all the component states belonging to the union.[216] Other taxes that affect interregional commerce must be levied in a manner that will not unduly impede such commerce.

3. *Relation Between Revenue and Expenditure*

Another important principle in the distribution of tax law making powers is the balance between revenue and expenditure. A certain overall equivalence between the amount of taxes that can be raised autonomously by local governments[217] and the volume of public outlays for which they are responsible is indispensable. This equivalence between taxing power and spending power is an indicator of the true degree of autonomy of local governments.

Of course, the constitutional setup can be organized in such a way that a local government does not raise its own revenue but is subsidized by grants from a higher level of government; that is, the federal government raises the revenue and transfers the funds to local governments. This mechanism is often used in federal states to transfer funds from richer regions to poorer regions.[218] The system of financing through grants, in which different governments are responsible for raising revenue and spending it, can lead to problems.

In a system of financing local government through grants, it is difficult to maintain true autonomy of local government. On the one hand, uncondi-

[216]The classical example is the European Union, which has a common customs system, although the common rules are administered by independent national customs administrations.

[217]The term "local" government includes regional levels of government.

[218]*See, e.g.*, for Germany, the *Bundesfinanzausgleich* [Federal equalization of finances] in art. 107 of the Constitution. The United States had so-called revenue-sharing provisions for a time, but they have been dropped. State and Local Fiscal Assistance Act, Pub. L. No. 92-512, Title I, 86 Stat. 919 (1972).

tional or unlimited grants can lead to irresponsible behavior by local governments, which will be inclined to spend at the expense of the central government. On the other hand, if the grants are subject to conditions set by the central government, the latter can choke off completely the autonomy of the local governments by imposing strict conditions on these grants or by restricting their amounts.

Besides the democratic substance of the tax system, budgetary principles call for a rough balance between taxing and spending powers: such balance reflects the true allocation of costs of government functions. In a system of financing local governments with unconditional grants, the burden of cost for the operation of a specific level of government is not reflected at the level of government that is spending. Therefore, it will be more difficult to determine the real operating cost of that level of government.

4. *Distribution of Tax Law Making Power with Respect to Certain Elements of the Tax*

In many cases, full legislative power for all elements of a tax is not vested in one particular level of government, but distributed over several levels of government. This is often the case when the revenue raised from a particular tax is shared by two or more levels of government.

The most frequent model is one in which the central government retains control over the determination of the subjects of taxation, the tax base, and the procedural rules, but the power to fix rates is shared with other levels of government. This model exists in several European countries and in Japan, whereby a surcharge of one or more national taxes is levied to benefit local governments.[219]

In some cases, besides the power to set the rates, part of the legislative power with respect to the tax base also belongs to regional or local governments. In other cases, simultaneous and full parallel taxing power on the same tax is held by federal and regional levels of government. Examples of this situation are not so common because the coexistence of two levels of legislative power over the same tax is a constant source of conflict. In Belgium, for example, the tax on estimated rental income from real estate is distributed among no fewer than four levels of government: the central state, the regions, the provinces, and the local municipalities. The central state determines the general rules for the tax base and includes this income in the tax base of the progressive income tax. The regions set a separate flat rate on the tax base as determined by the central state, but have the power to introduce certain exemptions from the tax base and to allow certain reductions of the amount of regional tax due. Finally, the provinces and the local munic-

[219]*See* International Tax Program, Harvard Law School, World Tax Series: Taxation in Italy 65–66 (1964); Hiromitsu Ishi, The Japanese Tax System 256–59 (1993).

ipalities are entitled to a surcharge on the amount of tax levied by the regions without any change of the tax base.

In Germany, the Federal Government theoretically shares its tax law making power with the state governments.[220] This parallel power is limited, however, by another constitutional provision stating that the state governments lose their lawmaking power when the Federal Government has legislated in a tax area.[221] In Canada, income tax is imposed on individuals and corporations under the Federal Income Tax Act. The provinces have the power to levy income tax on both individuals and corporations; generally, this power is exercised by setting a provincial rate of tax to be applied to the tax base established by the federal act, the tax being collected by the federal administration. Exceptions are Quebec, which has its own income tax law, and Alberta and Ontario, which have their own corporate income taxes.[222]

In the United States, the states theoretically have full taxing power, except for customs duties.[223] This taxing power is subject to some constitutional limitations, the most important of which is the interstate commerce clause,[224] which prohibits the states from obstructing interstate commerce by restrictions in the tax laws. States can therefore provide their own definition of taxable income, although in practice the federal definition is the starting point and the deviations from it are relatively limited in scope in most states. Tax rates differ from state to state, and some states do not even have an income tax. As a result of this parallel taxing power, conflicts on tax jurisdiction may arise between the federal and the state level, as well as among the states themselves. In Switzerland, the confederation and the cantons effectively share tax law making power for direct taxes on income and wealth.[225] Conflicts between certain types of tax legislation are solved by harmonization of the conflicting tax rules.[226]

Another example of this setup is the way in which customs duties are administered in the European Union. All the rules with respect to the subjects of taxation, the determination of the base, and the rates are determined by EU law. The tax administration and procedure (i.e., tax returns, control measures, tax protests, and litigation) are administered in accordance with the national law of the member states.

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[220]*Konkurrierende Gesetzgebung* (concurrent lawmaking). *See* GG art. 105/2 (DEU).

[221]*Id.* art. 72/2 No. 3.

[222]*See* the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, S.C., ch. F-8 (1993).

[223]*See* Const. art. 1, § 10 (USA).

[224]*Id.* art. 1, § 8, cl. 3.

[225]*See* Const. art. 41 *ter* (CHE); International Tax Program, Harvard Law School, World Tax Series: Taxation in Switzerland 140–42, 165–69 (1976).

[226]*See* Const. art. 42 *quinquies* (CHE) (*cited by* Rivier, *supra* note 110, at 42–43); *see also* Ernst Höhn, *supra* note 110, at 34.

5. *Distribution of Tax Law Making Power According to the Level of Implementation of the Tax*

Finally, it is possible to distribute tax law making power in accordance with the level of implementation of the tax. In this model, the general rules with respect to the subject of the tax, the tax base, and rates are fixed at the central level of government, while the more concrete details of the implementation of the tax are left to lower levels of government. For example, in Germany, regional tax authorities administer major federal tax laws for the account of the federal treasury.[227] Another example of this model can be found in the way the VAT and certain aspects of corporate income tax are implemented in the EU.

The VAT has been introduced in the EU by way of directive.[228] A directive is a legislative act issued by the Council of Ministers of all the member states, who decide by unanimous vote (in tax matters) to introduce certain tax rules. In this case, the basic rules determining the subject of taxation, the tax base, and part of the rules of procedure and administration (not the rates) have been determined by directive, leaving certain options to member countries. Each of the member states then implements the VAT through national laws. Disputes may arise when taxpayers argue that the national laws are inconsistent with the directive.[229]

The same pattern is emerging in the EU with respect to the corporate income tax. Certain requirements with respect to the treatment of corporate reorganizations and intercorporate dividends, which particularly affect corporate groups with members in more than one state, have been imposed by directive.[230] Further, in a report on the harmonization of the corporate income tax, a committee of independent experts advised the European Com-

[227]*See* GG art. 108 (DEU). On the basis of this article, regional tax authorities administer the personal and corporate income tax, the business tax (*Gewerbesteuer*), the VAT, and inheritance and gift taxes, as well as the road tax. *See* 3 K. Tipke, *supra* note 53, at 1130.

[228]Sixth Council Directive 77/388 of May 17, 1977, on the Harmonisation of Laws of Member States Relating to Turnover Tax—Common System of Value Added Tax Uniform Basis of Assessment, 1977 O.J. (L 145) 1; Second Council Directive 67/228 of Apr. 11, 1967, on the Harmonisation of Legislation of Member States Concerning Turnover Taxes—Structure and Procedures for Application of the Common System of Value Added Tax, 1967 O.J. (L 71) 1303; First Council Directive 67/227 of Apr. 11, 1967, on the Harmonisation of Legislation of Member States Concerning Turnover Taxes, 1967 O.J. (L 71) 1301.

[229]*See* Case C-35/90, Commission v. Spain, 1991 E.C.R. 5073; Case C-31/89, Commission v. Spain, 1990 E.C.R. 2139; Case C-120/88, Commission v. Italy, 1991 E.C.R. 621; Case 50/87, Commission v. France, 1988 E.C.R. 4797; Case 122/87, Commission v. Italy, 1988 E.C.R. 2685; Case 249/84, Ministère Public and Ministry of Finance v. Profant, 1985 E.C.R. 3237.

[230]*See* Council Directive 90/434 of July 23, 1990 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States, 1990 O.J. (L 225) 1; Council Directive 90/435 of July 23, 1990 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States, 1990 O.J. (L 225) 6.

mission to set certain minimum rules with respect to tax rates and tax bases beyond which member states should not go.[231] Within the outer limits established by these minimum rules, member states would retain full taxing power.

6. *Deduction or Credit for Regional and Local Taxes*

An important question in the distribution of revenue between various levels of government is whether a local tax is deductible from the tax base determined by the central government or whether it can be credited against the amount of tax due to the central government.

If a tax levied by a regional or local government can be credited without limit against a tax levied by the central government, the lower government, by increasing its taxes, can completely wipe out the tax revenue of the central government. An example of this is the tax on estimated rental income from real estate in Belgium. The regional, provincial, and local taxes on estimated rental income can be credited against the progressive personal income tax levied by the Central Government; that is, the amount of tax due to the lower governments is deducted from the amount of tax due to the Central Government and only the balance has to be paid. To prevent the regional and local governments from reducing the Central Government's revenue by increasing their taxes, the Central Government has set a limit on the amount of tax that can be credited at 12.5 percent of the tax base.

A similar problem arises when local taxes are deductible in determining the base of a tax levied by the central government. Recent examples of this are environmental taxes, such as taxes on litter or the use of water, levied by regional or local authorities, that are deducted from the corporate income tax base. As the local tax burden increases, the tax base for the central government is reduced.

7. *Distribution of Tax Law Making Powers in a Centralized State*

The distribution of tax law making powers in most centralized states is fairly simple because there are only two significant levels of government: central and local. The local government in most cases is too small to administer any of the important taxes, so the power to impose the most important taxes rests with the central government.

In a typical centralized state, all major modern taxes are levied by the central government. All aspects of legislative power over these taxes rest with the central government, and local governments are not involved in their

[231] Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation (1992).

implementation or administration. Allocation of revenue to local government is typically governed by a law on local finance.[232]

The problem in such centralized states is that local governments may not have adequate taxing power. While it is not possible to make a complete inventory of taxes levied by local governments, some patterns of taxation do emerge. Local governments in many Western European countries are typically financed by surcharges on personal or corporate income tax, surcharges on national road taxes, taxes on real estate, and taxes on business activity. There is often a ceiling on the amount of local surcharge to be levied. Taxes on the estimated value of real estate, on rented rooms or hotel rooms in tourist sites, or on second residences are categorized as taxes on real estate. Taxes on personnel or equipment used in the exercise of a business, taxes on business offices or the authorization to open a local business, or taxes on turnover or on the exercise of a business are categorized as taxes related to a business or professional activity. Finally, taxes such as those on the collection of refuse and litter, sewer connections, and the delivery of passports and public certificates relate to services provided by the local administration.

As the financial needs of local governments grow, the proliferation of all types of taxes increases the tax burden and can make the local tax "system" incomprehensible and obscure. Therefore, it is preferable to reserve a few major sources of revenue, such as surcharges on personal and corporate income tax, for local governments, so that they are not obliged to raise taxes arbitrarily.

8. *Distribution of Tax Law Making Powers in a Federal State*

The distribution of tax law making power in a federal state is much more complex than in a centralized state because there is at least one additional level of government (the regional government) large enough to administer a major modern tax system. In a federal system, the question is how to distribute tax law making power with respect to major taxes while maintaining economic and monetary union. In a federal state, both the federal government and the states often have full power to raise important taxes, such as corporate and individual income tax and sales taxes. A single corporation may be liable to corporate income tax in all the states in which it does business. This raises the risk that either (1) the various states in which the corporation operates will each seek to tax more than their appropriate share of the corporation's income, thereby leading to multiple taxation of the same income, or (2) the corporation will take advantage of the different tax rules operating in each of the states to arrange its affairs so that much of its income escapes taxation.

[232]*See* Nieuwe Gemeentwet [New Law on Local Government], Koninklijk Besluit [King's Decree] of June 24, 1988, B.S. 12.465 (Sept. 3, 1988)(BEL).

The problems involved in limiting the taxing authority of regional governments are beyond the scope of this book.[233] In countries where regional governments enjoy fiscal autonomy, there is usually substantial litigation concerning these limitations.

233*See generally*, for Belgium, A. Alen, Treatise on Belgian Constitutional Law 256–62 (1992); for Switzerland, World Tax Series: Taxation in Switzerland, *supra* note 225, at 103–106; for the United States, 1 Jerome R. Hellerstein & Walter Hellerstein, State Taxation, chs. 4, 5 (2d ed. 1993).

3

Drafting Tax Legislation

Victor Thuronyi

> In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.
>
> —*Learned Hand, The Spirit of Liberty*

I. Introduction

Drafting tax laws is a subspecialty of legislative drafting in general.[1] This chapter does not attempt a comprehensive treatment but serves as an introduction, focusing on questions that have been of particular concern in drafting

Note: The author is grateful for comments from Lloyd Ator, Susan Himes, Ward Hussey, and Bertil Wiman, and to Rick Krever, who contributed to the writing of sec. IV(D).

[1]For more general treatments, *see* Lawrence E. Filson, The Legislative Drafter's Desk Reference (1992); Robert J. Martineau, Drafting Legislation and Rules in Plain English (1991); David Renton, The Preparation of Legislation: Report of a Committee Appointed by the Lord President of the Council, 1975, Cmnd 6053; G.C. Thornton, Legislative Drafting (3rd ed. 1987); Elmer A. Driedger, The Composition of Legislation (1957); Reed Dickerson, Legislative Drafting (1977); S. Namasivayam, The Drafting of Legislation (1967)(U.K.-style drafting, with particular emphasis on Ghana and Ceylon); Louis Philippe Pigeon, Drafting and Interpreting Legislation (1988)(focus on Canada and Quebec in particular, but much of discussion is of general interest); Law-Making and Development: Formulating Policies and Drafting Legislation (Seyoum Haregot ed., 1987) (collection of essays on the role of legislation, legislative drafting, and related topics, with special emphasis on developing countries); V.C.R.A.C. Crabbe, Legislative Drafting (1993) (focus on Commonwealth practice; appendix contains Canadian guidelines on preparation of legislation); William Dale, Legislative Drafting: A New Approach (1977) (comparative study of methods in France, Germany, Sweden, and the United Kingdom). The best (and funniest) short piece on drafting I have read is Ward Hussey, Homily on Drafting Style (as yet unpublished).

tax laws. The focus is on drafting technique, other matters relating to drafting being considered elsewhere in the book.[2] In addition, the chapter is limited to considerations that apply generally, regardless of language or jurisdiction. Because languages and local drafting styles differ, the approach to drafting a tax law will vary widely from country to country.

Those who draft tax legislation in developing or transition countries usually are not subspecialists in this area (i.e., lawyers who have specialized in legislative drafting and in particular in the drafting of tax legislation). Local officials responsible for drafting typically are tax experts in the ministry of finance, and are not often lawyers or specialists in drafting. Foreign advisors who assist them can be lawyers, accountants, or economists with a background in taxation, but do not usually have an expertise in legislative drafting.Therefore, this chapter explores some of the lessons that can be learned from specialists in legislative drafting.

The effectiveness of a tax law is enhanced if its words are meaningful, intelligible, well thought out, and well organized. Many tax laws do not come close to meeting these criteria. The tax laws of countries with established and sophisticated systems can be particularly impenetrable, as qualifications and exceptions have been heaped on top of existing rules. In this sense, those working in developing and transition countries have an opportunity to produce better laws than exist in developed countries. Poor drafting often leads to substantial problems in implementation of a new tax law that could have been avoided. A goal of this chapter is to encourage those involved in the tax legislative process to devote greater attention to drafting technique.

The discussion in this chapter is organized according to the criteria for a well-drafted law. I have identified these as understandability, organization, effectiveness, and integration. Understandability refers to making the law easier to read and follow. Organization refers to both the internal organization of the law and its coordination with other tax laws. Effectiveness relates to the law's ability to enable the desired policy to be implemented. Finally, integration refers to the consistency of the law with the legal system and drafting style of the country. These criteria are, of course, interrelated and somewhat overlapping. Organization is important for understandability, and all the criteria contribute to the effectiveness of the law.

In the most general terms, the tax laws should be drafted so as to best fulfill their role in the tax system, which is to specify such matters as how much each taxpayer is liable to pay and what the taxpayer's rights and obligations are.

A well-drafted tax law spells out with precision the matters that are within its scope. But precision is not enough. A law should not be precise at the expense of being complicated and impossible to understand. The easier

[2]For example, discussion of the drafting process and legislative process in general in ch. 1, the legal framework in ch. 2, and drafting problems that relate to specific taxes throughout the book.

a tax law is to understand, the lower will be the compliance costs, both for taxpayers and for tax administrators. It is particularly important that a tax law be easy to apply (compared with other public law, for example, a law governing the generation of toxic waste or one governing building codes) because the tax law applies to nearly every physical and legal person in the country with respect to countless transactions every day. The fact that tax law must be applicable to so many transactions in an efficient manner has an important influence on how the law must be drafted. In particular, there is little room for sloppiness. Finally, a tax law must be effective in achieving the policy goals of the legislator, both in terms of the amount of revenue to be raised—with an eye to equity, efficiency, and simplicity—and the items and persons to be taxed. Good drafting goes hand in hand with the specification of policy.

These criteria sometimes conflict. For example, a simple statute may be rejected as inequitable, because it does not recognize the differences in situation of different taxpayers. A statute that provides too much certainty may conflict with the goals of equity and revenue raising (because the certainty can be exploited by tax planners). In many cases, however, there is no conflict; complexity that is merely the result of bad drafting can be eliminated while at the same time providing greater certainty and a clearer articulation of the policy.

II. Understandability

A. Brevity

The shorter the statute, the less effort will be required to understand it, and the lower compliance burdens will be. Elegance, brevity, and clarity of expression are therefore to be sought. Every word in a statute should have a definite purpose and no unnecessary word should be used.[3] In addition to being easier to understand, a more elegant statement often better articulates the policy of the law. For example, on reviewing an initial draft of a statute, the drafter might notice that several rules, perhaps located in different parts of the statute, could be combined into one general rule that covers what previously appeared as unconnected details. (This is one example of the close interrelationship between the development of policy and the process of drafting.)

The prescription for brevity does not necessarily mean that a shorter statute is better than a longer one. It may be determined that certain details need to go into the statute, and it takes additional words to express these details. Moreover, the expression of an idea in so few words that it becomes cryptic and understandable only after careful study also constitutes an extreme to be

[3]Driedger, *supra* note 1, at xxii.

avoided. The point is simply that no word should be included if it does not serve a function.

How long the optimum law would be for a particular tax is an interesting philosophical question and an important one in drafting a new law. Whatever the answer in the abstract, much more important is the local situation. The local officials who will be working with the new law must make it their own. The constraint in terms of length is often how much can be absorbed by those who will be using the law. Because taxation suitable for a market economy is a recent phenomenon in transition countries, the length of the tax laws in such countries can be expected to increase as their experience with taxation grows. One implication is that the tax legislative process for these countries has only just begun.

B. Transparency

A statute is transparent if it easily allows the reader to understand the rationale for the rules.

One way of achieving transparency is to begin a law by stating its purpose.[4] If the statement is very general, it is not helpful. On the other hand, a very general statement can do little harm. (E.g., an income tax law might begin: "This law levies a tax on income.") If the statement is made more specific and operational, then it could serve a function by indicating the overall legislative purpose so as to facilitate interpretation of ambiguous provisions. In the case of some legislation, this might be helpful. For example, a piece of environmental legislation might stipulate that the purpose of the legislation is to eliminate pollution wherever technically feasible, regardless of the cost, or it might provide the opposite, that the statute should not be construed as requiring measures to be taken whose costs are disproportionate to the environmental benefits. Either philosophy, if articulated by the legislature, would give guidance to the courts as to the legislative intent.

In the tax area, however, it may be dangerous to make an overriding general statement of the legislative purpose, because the courts may interpret the provisions of the statute in light of this stated purpose and may be misled in doing so. It is difficult to avoid a misleading statement of purpose, because tax laws are highly technical and, in some cases, artificial. For example, person X might be denied a deduction because that is an administratively more feasible approach than taxing person Y on the payment received from person X.[5] The result is that person Y is not taxed on the payment and person X is denied a deduction that should be available under general principles. This would hardly square with a general statement to the effect that "each taxpayer shall pay tax

[4] *See, e.g.*, 16 U.S.C. § 1531(b) (USA) (purposes of Endangered Species Act). *See generally* Dickerson, *supra* note 1, at 107–108; Renton, *supra* note 1, at 30, 62–63.

[5] *See* vol. 2, ch. 14 (discussion of different ways of taxing fringe benefits).

on the taxpayer's net economic income." Not only do the tax laws contain artificial provisions, but they are also prey to competing policy goals. Some deductions are allowed because they accurately reflect net income, others because of a legislative purpose to encourage a particular activity; in some cases, motives for providing a deduction are mixed. Because of the disparate and competing policies behind tax legislation, it becomes difficult to describe the general purpose of the law in operational terms. Tax laws therefore have generally not included a statement of purpose. Recently, however, in New Zealand, legislation has been introduced that states the purpose of the income tax act and provides an underlying framework for it.[6] If adopted, it will be interesting to see how this works.

Instead of stating the law's purpose, the law could begin with an exposition of its basic mechanics, that is, identification of the taxpayers, tax base, and location of provisions containing the rates. This would be more modest than attempting to state the purpose of the law, but it would at least allow the reader to see the basic structure of the law at the beginning. Whether this approach is suitable in a particular case will depend on local drafting style.

C. Avoiding Legalistic Language

Advocates of "plain language" drafting recommend avoiding legalistic language, so as to make the law easier to understand.[7] Where legalisms are verbose or obscure, they can make comprehension more difficult, and they should be eliminated if possible. For example, artificial terms with meanings defined in the tax law should be used sparingly, as their use will often be confusing to a reader who is not thoroughly familiar with the statute. On the other hand, the use of legal terms or other terms of art can make the statute precise and shorter when these words have a technical meaning or a meaning determined by legal rules outside the tax law. For example, concepts such as corporation, partnership, employee, contract, mortgage, or lien may be well defined by laws outside the tax laws, and it is appropriate to use these words rather than simpler words that might be more understandable to laypersons. It is sometimes appropriate, however, to adopt a modified meaning for tax purposes.[8] One should therefore not hesitate to use technical terms where appropriate, even if a layperson might as a result have greater difficulty in understanding the statute. While it is nice if portions of the tax laws are comprehensible to nonlawyers (or even to non–tax lawyers), and the law should be so drafted if precision is not sacrificed, comprehensibility to the layperson should not be an absolute

[6] *See* Adrian Sawyer, *New Zealand Introduces New Core Provisions Bill*, 12 Tax Notes Int'l 539 (1996).

[7] *See* Martineau, *supra* note 1, at 90–92.

[8] *See infra* sec. V(C).

requirement in an area as technical as tax law.[9] A tightly drafted statute can be translated to the layperson in the form of instructions.

D. Numbering of Sections[10]

Most countries have adopted the practice of numbering the sections of a statute sequentially, that is, 1, 2, 3, and so on.[11] While this is fine for a statute that will never be changed, most tax laws are amended frequently. Amendments create problems for sequential numbering. Either amendments have to be placed at the end of the statute, in which case they are not in the logically appropriate place; or they can be inserted in the appropriate place, but the sections of the statute have to be renumbered; or they can be inserted under a hybrid alphanumerical designation. Except when legislation is completely overhauled, renumbering is confusing and should be avoided because references to section numbers in other laws, in legal documents, in judicial decisions, in regulations, and in articles and other descriptive materials become incorrect.

Renumbering can be avoided by inserting new sections between the existing sections. However, this can lead to bizarre and confusing designations for sections.[12] The solution adopted in the U.S. Code (one title of which is the Internal Revenue Code) is nonsequential numbering. The approach is to leave a gap in section numbering between each division of the statute. If new sections are added, they can be assigned the unused section numbers. For example, the first group of sections might run from 1 to 14, and the next group begin with section 20. One might object to this on philosophical grounds (the section numbered 20 is not the twentieth section, but only the fifteenth), but section designations like "238 *bis*" seem equally objectionable to me (how can there be a first section 238 and a second section 238?). If tradition can be overcome, nonsequential numbering offers an advantage.[13]

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[9]*But see* Martineau, *supra* note 1, at 91 (legislation should be drafted so that it can be understood by a person of average intelligence). The taxpayer's contact with the law itself may be minimal. Most people will rely on explanations of the law issued by the tax authorities, and considerable care should go into writing such explanations. These should be written in language understandable by laypersons. *See also* Renton, *supra* note 1, at 112–13.

[10]"Section" is used in this chapter to refer to the basic unit of a statute. In some countries, particularly in the civil law tradition, "article" or "paragraph" is used.

[11]*See, e.g.*, Thornton, *supra* note 1, at 59–60.

[12]For example, the following articles exist in the FRA CGI: art. 235 *ter* EA (which comes after art. 235 *ter* E), and art. 235 *ter* H *quater* (which, obviously, comes right before art. 235 *ter* HA, which would, presumably, if it had been enacted after art. 235 *ter* H *quater*, have been called art. 235 *ter* H *quinquies*). So far, the Parliament has not found the need to insert an article between art. 235 *ter* HA and art. 235 *ter* HB, or, what would be even worse, an article between art. 235 *ter* H *ter* and art. 235 *ter* H *quater*.

[13]It is not a perfect solution, in the sense that assigning the unused article numbers to new articles might place the new articles in an order that is not quite logical. Often, however, new articles will be appropriately located in the places where gaps are left, since they will be in the nature of special rules, which are appropriately placed at the end of a group of related articles.

E. Section Headings

In many countries, sections do not have section headings,[14] but are simply designated by numbers.[15] The use of section headings makes it much easier to read and understand the law; moreover, it imposes discipline on the drafter. If the drafter cannot think of a good heading for a section, it may be because the section contains disparate subject matter, which would best be broken into more than one section. Recent legislation in a number of transition countries now contains section headings.[16]

If a decision is made to use section headings, the question arises whether headings for subdivisions of a section should also be used. For example, in the U.S. Internal Revenue Code, not only does each section have a heading, but each subsection and paragraph does too. This may be appropriate in a situation, such as for the U.S. Code, where even the subdivisions of a section are lengthy. In a sparser drafting style, the use of headings for subdivisions of articles would lead to clutter. A cluttered statute being more difficult for the reader to digest, there comes a point in the subdivision of a statute where the use of headings should stop. In most cases, my preference would be to do this at the level of the section, but the matter should be decided in light of the characteristics of the statute being drafted and of the country's drafting style.

Where section headings (or marginal notes) are used, the question of their legal effect should be considered; that is, to what extent should or will courts rely on the section heading in construing the statute?[17] It is generally best to keep the headings short (one to four words); this makes it clear that the heading will not capture all the nuances of the section it heads.

F. Sentence Structure

Long, complex sentences should generally be avoided because they impede understanding (in some cases, however, a lengthy sentence can express an overall thought more succinctly than shorter sentences). Some drafting traditions follow the opposite approach and actually encourage the use of longer sentences. In the U.K. tradition, a section may not contain more than one sentence unless broken down into separate subsec-

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[14]In the U.K. tradition, the term used is marginal notes, and these are, as the name implies, placed in the margin, except in New Zealand and Canada, where they follow the section number as a heading. *See, e.g.*, CAN ITA. *See also* Thornton, *supra* note 1, at 125–28.

[15]*E.g.*, France, Germany, and Spain. In such countries, however, parts of a statute (they may be called title, part, chapter, and the like) typically do have headings. *E.g.*, FRA CGI.

[16]For example, section headings are used in many of the recently adopted tax laws of Estonia. *See, e.g.*, EST LOT; EST IT; EST VAT; EST LND; EST GAM. Section headings are also used in some of the Russian and Latvian tax laws, as well as in the new Kazak code. *See, e.g.*, RUS IT; RUS PT; LVA TF; LVA EIT; LVA ET; KAZ TC.

[17]*See* Thornton, *supra* note 1, at 123–24, 127.

tions.[18] Drafters can and do, however, get around this rule by creating run-on sentences using conjunctions or semicolons. Horribly long sentences result. The injunction against more than one sentence in a subdivision makes little sense. Often, a rule is best expressed using more than one sentence, and it is easier to understand the rule if these sentences are located in a single subdivision. If the goal is elegance and comprehensibility, the U.K. rule should be abandoned. However, tradition sometimes dies hard, and it is possible, although not ideal,[19] to work within the constraints of the U.K. rule in jurisdictions that adhere to it.

Another question of sentence structure is whether a sentence should be broken down by numbering and indenting its logical components. This has been called "paragraphing."[20] Paragraphing is to be recommended on two closely related grounds: it is a means of removing ambiguity, and it makes sentences easier to read. Paragraphing reveals the logical structure of a sentence at a glance; it divides the sentence into elements that can more readily be comprehended one at a time and shows graphically the relationship between these elements.

For example, consider the following sentence:

The property income derived—
  (a) from a foreign source; or
  (b) from the disposal of an investment or asset generating foreign-source income
by an expatriate taxpayer is exempt from income tax.[21]

Paragraphing in this sentence makes clear that the condition in the flush language ("by an expatriate taxpayer") applies to both items (a) and (b). It also allows specification on a self-contained basis of each of the elements of the sentence and allows the reader to quickly grasp the nature of the rule. If the paragraphing were removed, the sentence would possibly be ambiguous and would be more difficult to follow.

Paragraphing has its detriments, however. It makes the statute seem complex and abstract, where it might be easier to digest if the numbering and indentations were removed. This is especially the case when multiple tiers of

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[18]*See* Renton, *supra* note 1, at 64; Thornton, *supra* note 1, at 57. This tradition is followed in various countries of the Commonwealth, such as Canada and Australia.

[19]Run-on sentences can be avoided by dividing them into several subsections. However, this leads to less-than-ideal clarity of organization of sections, since sections are as a consequence broken down into too many subsections. For example, it might be ideal to divide a particular section into three subsections if the section contains three main thoughts. Each of these subsections might consist of two sentences. But if this is prohibited, then the alternative is to divide the section into six subsections of one sentence each. In this case, the benefits of breaking out the section into its three main thoughts are lost. An example of a statute drafted under the one-sentence rule, but where the sentences have been kept fairly short, is LSO IT.

[20]*See* Renton, *supra* note 1, at 64–65; Thornton, *supra* note 1, at 57.

[21]LSO IT § 24.

subdivisions are used. Perhaps the most extreme example of this is the U.S. Internal Revenue Code, which regularly subdivides individual sections into several layers. Paragraphing should therefore not be overused, and the number of tiers of subdivision should be limited (more than two tiers is rarely necessary).

When sections of a statute are divided, it is desirable to adopt a uniform style for division, thereby allowing for easy identification and reference to subdivisions of a section.[22] A contrast to this is the division style of the tax code of France, which is inconsistent. In some cases, articles are divided into paragraphs that are not numbered (i.e., there is just indentation).[23] In other cases, the first division of an article is numbered according to Roman numerals,[24] and in other cases, it is numbered with Arabic numbers.[25]

III. Organization

A. General Issues

Logical organization of a statute aids comprehension. If the statute is well organized, it is also easier to determine where one needs to look for the answer to a particular question, and which portions of the statute can be ignored by a particular taxpayer. Each tax law contains the same key elements (taxpayers, rates, tax base, procedure, and administration), and understanding is improved if all the tax laws of a particular country follow the same order in respect of these elements. Foreign advisors in particular should consult the local practice in this respect.

Organization requires grouping together provisions on the same topic. Moreover, each subdivision of the statute, including individual sections, should be constructed in an order that facilitates comprehension. Usually, this means stating the general rule first and following it with exceptions and special rules for particular cases.

Proper organization is as important for the drafter as it is for the reader of the statute. The organization of a statute is like the framing of a house. Organizing rules helps the drafter think them through. If the drafter is forced to think about where in the statute a particular section should go, then he or she will think more carefully about its function, which will help in understanding and formulating the rule. It might occur to the drafter, for example, that what

[22]For example, in the Internal Revenue Code (and more generally, in the U.S. Code), sections are divided into subsections (designated by lowercase letters), then into paragraphs (Arabic numbers), subparagraphs (uppercase letters), clauses (lowercase Roman numerals), and subclauses (uppercase Roman numbers). Correspondingly, there is a uniform designation of groupings of sections in the U.S. Code. The U.S. Code is divided into titles, subtitles, chapters, subchapters, parts, and subparts.

[23]*E.g.*, FRA CGI art. 223 J.

[24]*E.g.*, FRA CGI art. 238 *bis* HA.

[25]*E.g.*, FRA CGI art. 223 L.

started as a rather particular rule should be rewritten as a more general rule that goes elsewhere in the statute. Grouping rules together also helps the drafter figure out whether any pieces are missing.

There are many examples of bad organization.[26] One is the failure to divide a long statute into parts, thereby forcing the reader to hunt through the entire statute in search of the relevant provisions. Another example, which is typical of the U.K. tradition, is the use of schedules. For example, there are 31 schedules to the Income and Corporation Taxes Act 1988 (U.K.). While it may seem commendable to relegate detailed provisions to a schedule in order to make the statute easier to read, the result is simply bad organization.[27] Detailed provisions should either be in the appropriate place in the statute, or, if they are elaborations of general statutory rules, could be placed in regulations that are subordinate to those rules. The failure to integrate schedules with the statute not only makes the statute more difficult to follow, but also tends to undermine its logical integrity. A tightly drafted tax statute contains many explicit or implicit[28] cross-references. The logical interrelations among its provisions are intricate. If some of these are removed to a schedule, there is a danger that they will not be adequately integrated into the logical structure of the rest of the statute, particularly once there are amendments.

B. Use of a Code

A number of countries have organized their tax laws into a single code.[29] The use of a code facilitates the elimination of duplicative provisions. For example, without a code, definitions or administrative provisions might be repeated in separate laws or, even worse, might differ in two different tax laws because of historical accident.[30] Consolidating common provisions into a code

[26]*E.g.*, AUS ITAA.

[27]*But see* Renton, *supra* note 1, at 68–69. There may be political or parliamentary reasons for the use of schedules, where they can be changed by a process different from statutory amendment; this makes their use understandable, but does not remove the criticism that they make the statute more difficult to follow.

[28]"Implicit cross-reference" means the use of a term whose meaning is specified elsewhere in the statute.

[29]For example, Cameroon, Colombia, Côte d'Ivoire, France, Gabon, Kazakstan, Madagascar, Mali, Togo, and the United States. Even in countries where a code is used, there are some tax provisions, usually of very narrow application, that have not been included in the code. For example, in the United States, provisions that allow a deduction from taxable income for federal income tax purposes for amounts deposited in a capital construction fund for merchant marine vessels are contained in the Merchant Marine Act, 46 U.S.C. § 1161, not in the Internal Revenue Code.

[30]Use of a code does not, however, guarantee that duplicative provisions will be eliminated. For example, the Internal Revenue Code contains numerous definitions of "related person," with little policy justification for such multiplicity. It is not enough to put the tax laws into a code; one must also "think code," in the sense of consolidating detailed provisions into a smaller number of more general rules.

facilitates their rationalization because it forces one to think about what the general rule should be. Putting all the tax laws into one code also facilitates compliance, because taxpayers know that they have all the tax laws in front of them when dealing with a particular problem. In the absence of a code, people can waste time searching for tax laws in an effort to ensure that they have a complete set. This function of a code—gathering all the tax laws into one document—is an important benefit and argues in favor of using a code if at all possible.

Organization of all the tax laws into a single code is consistent with the civil law tradition. Some scholars in this tradition hold that only the general rules of taxation should be embodied in a code, with the more specific and ephemeral rules contained in specific tax laws, which can be expected to be changed more frequently.[31] Whatever is included in a code, in the tax area the use of codes does not correlate with whether a country has a civil or common law system. While France has a tax code, many other civil law countries do not. And even though the United States is a common law country, it does have a code.

C. Organization of Tax Laws in the Absence of a Code

The above considerations suggest that it is desirable to place all tax laws in a code. However, this might not be possible in a particular country because it would require consensus on a substantial legislative project of codification. When a code is not used, it is possible, albeit with some effort and discipline, to achieve virtually the same result by carefully organizing the separate tax laws, making sure they fit together properly, using cross-references where appropriate to eliminate duplicative provisions, and collecting provisions of general application into one law. In many countries, the tax laws are well organized, despite not being formally embodied in a code. For example, in Germany, the *Abgabenordnung* (Fiscal Statute) contains many of the provisions that apply to the tax laws generally; a number of other countries follow a similar approach of placing general rules into one law.[32] This avoids repetitive or inconsistent rules for different taxes.

Where all the tax laws are contained in one code, amendments are automatically consolidated into it, since they take the form of adding sections to it or repealing or replacing the language to be changed. This type of amendment is called a "textual amendment" because it is an amendment to the text of the previous law. It is desirable to make amendments in this manner, because a se-

[31] *See* José M. Martín & Guillermo F. Rodriguez, Derecho Tributario General (1986). This approach is followed by a number of Latin American countries. *See infra* note 32; 1 Carlos Fonrouge, Derecho Financiero 41, 48–63 (Susana Navarrine & Rubén Asorey, rev. 1993).

[32] *See, e.g.*, BEL CIR; AUT BAO; ESP LGT; RUS TS; EST LOT; CHL CT; ECU CT; PER CT; DOM CT; CHN TA; KOR BNTA; BRA CTN; MEX CF.

ries of nontextual amendments makes it difficult to ascertain precisely what the law is, often necessitating a tedious task of ex post consolidation of amendments.[33] One advantage of a code is that it encourages the legislature to make textual amendments.[34]

There is no hard and fast rule as to how many tax laws there should be. The same arguments that favor a code also suggest that the fewer tax laws the better, although one can in principle achieve close to the same result with more tax laws, as long as they are carefully coordinated. For example, Germany has two income tax laws, one for corporations and one for individuals, but the corporate income tax law is much shorter and incorporates much of the individual income tax law by reference.[35] In practice, however, such coordination is difficult to achieve with a multiplicity of laws; coordination is more likely to occur if several tax laws are merged into one.

Particularly problematic is the inclusion of provisions relating to a particular tax in more than one piece of legislation, together with nontax provisions, as often happens, for example, when tax provisions are contained in foreign investment laws or in laws designed to regulate particular industries. The interaction of the various rules for a particular tax is apt to be neglected when they are spread over more than one law.

IV. Effectiveness

The fundamental test of whether a tax law is drafted properly is if it implements the desired policy in an effective manner. In trying to make sure during the drafting process that the law will be effective, it is necessary to reflect on the policy and on the anticipated implementation of the law, including its interpretation in regulations and by the courts, and on how taxpayers and tax administrators will act in applying the law.

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[33]*See* Renton, *supra* note 1, at 32, 76–84. The Renton Committee considered it desirable to proceed by textual amendment wherever possible, but found that "there will be many circumstances in which the amendment of fiscal legislation by the textual amendment method will not be practicable." *Id.* at 117. It is, however, difficult to see what these circumstances are. Most amendments to tax law in the United States and many other countries are textual, so it is evidently possible to proceed this way. The failure to do so ultimately leads to a mess. The United Kingdom has been moving toward a more consolidated approach in recent years. For example, most of the laws relating to income taxation have been consolidated into the Income and Corporation Taxes Act 1988, and many amendments are now being made as amendments to specific sections of this act.

[34]Again, the use of a code does not guarantee this result. For example, in the United States some tax provisions are "off code"; that is, they are considered to be of such narrow application as not to be of general interest.

[35]*See, e.g.*, DEU KStG §§ 7, 8. A similar approach is followed in several other countries. *See also* NLD Vpb.; ESP IS.

A. Relation Between Policy and Drafting

To properly manage the drafting of tax legislation, it is important to understand the relation between policy formulation and drafting. It is, of course, necessary to make some tentative general decisions about the policy to be implemented before sitting down to draft specific legislative language. Yet in substantial ways policy does not precede drafting, the two being developed concurrently. In the first place, policy shifts as the political process of producing a tax bill unfolds. Initial responsibility for producing a draft bill might lie in a department of the ministry of finance. Often, governmental process calls for producing a complete draft even before the minister makes certain policy decisions. Changes in policy may then be made at several stages, as a tax bill undergoes consideration by the government and then by the legislature. Policy decisions can be changed up to the last point when a bill is finally adopted as law.

Second, it is impossible to decide whether a policy is wise without considering the text of the bill. The drafting process involves a constant refinement of the policy decisions. This is because drafting forces the policy to be specified more and more precisely. As this specification takes place through the consideration of tentative legislative language, numerous questions arise for the consideration of those who are responsible for the setting of policy. If certain tentative policy decisions are made before drafting begins, the drafter must thoroughly understand not only what those decisions are, but the reasons behind them. Only by fully understanding the policy choices and the reasons for making them can the drafter propose legislative language to accomplish the policy.

In the end, there is only the language of the law. Policy may still exist, in the sense of what various individuals may intend or hope for the bill to accomplish, but the state of mind of various individuals does not become the law. Tax policy in an objective sense subsists only in the language of the law. Therefore, the drafting process can be seen as the development of tax policy, which is inchoate at the beginning of the drafting process and fully realized only at the end of the process. It would therefore be more accurate to say that while tentative decisions as to the general direction of a draft bill must be made before specific language can be drafted, at that point the language of the draft and the policy behind it typically proceed hand in hand through the process until the final language is adopted.

B. Anticipating Application and Interpretation

During the drafting process, consideration should be constantly given as to whether the statute is complete. To be effective, the statute should set forth all the rules needed to determine tax liability, or should provide authority for regulations that will contain these rules. To achieve this, the drafters must try

to imagine all possible situations in which the statute will be applied. As part of this exercise, the drafters would do well to consult the accumulated experience of other countries and identify the issues that have come up in applying particular kinds of provisions. A choice must be made as to (1) whether rules go into the statute or into regulations[36] and (2) what level of detail is appropriate. Both choices may appropriately be made differently in different countries and for different kinds of issues.

Another aspect of thinking about how the law will be interpreted and applied is being on the lookout for ambiguity. Unnecessary ambiguity should be eliminated, although given that language is inherently ambiguous, it is impossible to eliminate all ambiguity. It is appropriate to take a practical view here and to eliminate ambiguity that would be of concern to a judge attempting to interpret the tax law. In some cases, a degree of ambiguity is desirable, because it provides flexibility for the tax administration to respond to unanticipated cases. For example, in drafting an income tax, one could list all the types of deductible business expenses. This would provide certainty, but not enough flexibility. It is better to provide a general rule, such as that all expenses incurred in the realization of income subject to tax are deductible, with specified limitations. Such a rule involves some ambiguity, but on balance is preferable to a rule that attempts to list all allowable deductions in that it accomplishes the goal of taxing net income.

More generally, in drafting it is important to anticipate the administrative or judicial resolution of disputes between taxpayers and the tax authorities. For example, suppose that it is decided to allow an income tax deduction for business entertainment expenses only if the expenses are reasonable in amount. If the statute is drafted in these terms, the drafters should consider who is going to decide whether an expense is reasonable. Will this be determined according to guidelines provided by regulations, will it be left to the judgment of individual auditors, or will it be left to the courts? If the drafters focus on these questions of procedure, alternatives for how to draft the statute might occur to them. For example, instead of using a concept of reasonableness, the statute could deny deductions for entertainment in excess of specified limits or could deny a fixed percentage of entertainment deductions or could deny this deduction altogether. Each of these alternatives is progressively simpler from the point of view of tax administration and progressively harsher for taxpayers. A policy choice must therefore be made. This is another example of how policy choices are generated and facilitated by the drafting process.

C. Drafting for a Judicial Audience

Just as any piece of writing is modified to cater to its audience, the manner in which laws are drafted should take into account how courts are expected to

[36]*See infra* sec. IV(D).

interpret them.[37] For example, the Renton Committee distinguished in general terms between the civil and common law systems.[38] It found that under the civil law system, legislation tends to be drafted in the form of broad statements of principle, with the application of these principles to particular cases being left to the judgment of the court. Classic civil law drafting practices "a deliberate restraint in the proliferation of detailed rules."[39] In contrast, common law drafting tends to be much more detailed, trying to cover each possible case, with the court taking a correspondingly narrower reading of particular provisions of a statute.

Of course, these characterizations of the judicial and corresponding statutory style in the civil and common law systems are only ideal types, and practice in particular countries and with respect to particular types of legislation may vary.[40] Tax laws in civil law countries are often rather detailed. Moreover, the level of detail can vary depending on the legislature's attitude about delegating its lawmaking authority. In any legal tradition, the tax law itself can be drafted in very broad terms, as long as there is a broad delegation of authority to issue detailed regulations. Whether a legislature wishes to do this is often a political question, and also depends on tradition and the framework of administrative law.[41]

In addition to the question of the level of detail of a statute, in common law jurisdictions, it is important to be aware of judicial decisions on taxation, as many important principles are governed by a "common law" of taxation.[42] This is less likely to be the case in civil law countries, or when the legislature has made an attempt to codify the tax laws. Even in a country like the United States, which has a code, an extensive common law of taxation has grown up under the guise of interpreting the provisions of the statute. Congress can always override judicial decisions, but U.S. courts tend to stick to the doctrines they have developed absent a clear congressional statement that they must be abandoned in a particular area.

The interpretation of law by courts can itself be governed by rules set forth in legislation. Commonwealth countries have developed a tradition of interpretation acts, which provide definitions of commonly used terms and may contain other clauses relating to the interpretation of laws.[43] In the United States, similar provisions are found in Title I of the U.S. Code. An analogy in civil law countries is found in the portion of the civil code contain-

[37]*See* ch. 2, sec. III.

[38]*See* Renton, *supra* note 1, at 51–55.

[39]*Id.* at 51.

[40]The Renton Committee provides a historical perspective on statutory detail in England, with the older statutes in laconic Latin ceding in the Middle Ages to verbosity, perhaps owing to the use of conveyancers to draft legislation. *See id.* at 5.

[41]*See infra* sec. IV(D).

[42]*See* Barry Pinson, Pinson on Revenue Law 3 (1981).

[43]*See* Thornton, *supra* note 1, at 87–93.

ing general provisions on the application of laws, although these tend to be less detailed than the interpretation acts of the Commonwealth.[44] With respect to tax legislation in particular, guidelines of interpretation for the courts are sometimes included in the tax laws.[45]

D. Relation Between Statute, Regulations, and Other Explanatory Material

Because tax legislation is often difficult to understand, new tax laws are often accompanied by explanatory documents of various kinds, which provide legislators, tax officials, and taxpayers with an understanding of their purpose and intended operation. To ensure effectiveness, statutes should be drafted with a view to what will go into these documents. It is not usually considered appropriate to try to provide all the necessary details of tax legislation in the statute. To do so would make the statute unduly lengthy and difficult to understand. Moreover, because one cannot foresee all the situations in which tax laws will be applied, all the details cannot be worked out at the time the statute is enacted. Finally, even if the drafters of the statute had in front of them the detailed rules needed to implement the statute, they might choose to leave these rules to be promulgated by the administrative branch, since administrative rules can be modified more easily than the statute.

Categories of explanatory materials may be called different things in different countries, but here are some examples:

Issuer	Type of document
Legislature	Committee report, report of hearings, explanatory memorandum, reports of debate
Executive branch	Message accompanying legislation introduced in parliament
Minister or cabinet	Regulation, order, decree, rule, ordinance
Tax administration	Commentary on tax legislation, public ruling, private ruling, instructions, circular

These different documents may all be helpful to taxpayers and tax administrators in understanding the law, but they differ in their legal effect. Some have the force of law, some have persuasive authority, some have little binding legal effect.[46]

There is no hard and fast rule as to which provisions should go into the law and which into the regulations. Which provisions are viewed as essential ones that must go into the law depends on the practice in the particular coun-

[44] *See, e.g.*, Code civil arts. 1–6 (FRA).
[45] *See supra* ch. 2, sec. III.
[46] *See supra* ch. 2, sec. IV.

try and on politics—how much power over detail the legislature is willing to delegate. There is also the problem of time: legislative drafting is a laborious exercise, and there is a limit to how much detail can be drafted within the time frame for enactment. Neither can one easily prescribe in advance how much total legislative and regulatory text there should be to give guidance to taxpayers without smothering them in detail. It is usually best to expand the mass of regulations little by little as needed. Leaving matters to regulations can also be a political tactic; it may be difficult to reach consensus on particular points, and leaving these points to regulations can facilitate passage of a bill.

There are alternatives to issuing detailed regulations. One alternative is to provide no written rules governing details, allowing the broad principles of the statute to speak for themselves. Another is to provide that certain rules of the statute apply only where the tax authorities have given their approval in the particular case. This is a useful technique in the case of rules that govern what is expected to be a small number of cases. Instead of spelling out the rules for these cases in advance, it may be easier to proceed on an ad hoc basis.

Another alternative to regulations is for the tax administration to issue commentaries on the law. These can take varied forms. For example, in the United States, the Internal Revenue Service issues revenue rulings, dealing with the application of the law in certain situations (to be distinguished from rulings issued to particular taxpayers). Revenue Canada issues interpretation bulletins. The tax authorities of most countries issue instructions on how to fill out tax forms. In practice, these may be the only material consulted by the majority of taxpayers. While their legal significance may be minimal, their practical importance cannot be overstated. The U.K. tax authorities issue "extra-statutory concessions," explanatory booklets, and statements of practice.[47] The French tax administration publishes a book called *Précis de fiscalité*, which is a treatise nearing 2,000 pages in length covering all the rules of taxation.[48] These commentaries have varied legal effect; they are often binding on the tax authorities, but not on the taxpayer. Even if such administrative interpretations are not legally binding on taxpayers, for all practical purposes, if they are not directly contrary to the statute, taxpayers will often follow them.

Advance guidance on interpretation of the statute can also be provided in documents that are issued contemporaneously with consideration of the legislation, for example, in the form of an explanatory memorandum submitted by the government or in the form of a committee report (i.e., the report of the legislative committee considering the bill). The extent to which the courts will consider legislative history in construing the bill differs in different legal systems.[49] In U.K.-based systems, the matter can be dealt with in an acts inter-

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[47]*See* B. Pinson, *supra* note 42, at 3.

[48]Statement in text is based on the 1994 edition, which is approximately 2,000 pages long. It is not binding on the tax administration. *See supra* ch. 2, note 207.

[49]*See supra* ch. 2, sec. III.

pretation act[50] or in the statute itself.[51] As a practical matter, legislative history can play an important role, even if judicial doctrine does not assign it much legal force. Therefore, consideration should be given to preparing a detailed explanatory memorandum to accompany tax legislation, if acceptable as a matter of local practice.

It is important to be aware of the country's administrative law and practice with respect to delegated legislation. While we have reviewed in general terms the practice of several countries, there are many variations, and each country has its unique practices. These may pose real obstacles to what can be done in regulations. For example, there may be a practice or requirement in the law that regulations have to be issued contemporaneously with passage of the legislation (or within a specified period of time). The drafter should become aware of any such constraints in advance. When it is important for a rule to have binding legal force, then it may be necessary to include it in the statute if administrative practice does not readily allow it to be included in another legally binding norm. Inclusion of rules in the statute is also necessary if the statute is to operate at once, before regulations can be issued.

Attention should also be paid to providing in the statute for regulatory authority, which depends on the country's administrative law. Often a tax statute will contain a general authority for regulations. Even when this authority is provided, there are often additional grants of authority to write regulations to implement particular provisions of the statute. Multiplication of authority for regulations should be avoided on grounds of simplicity, but there is some excuse for special grants of authority when regulations that are legislative in character are called for, that is, where the regulations are providing rules out of whole cloth rather than filling in the details of rules provided in the statute. The distinction between legislative and interpretative regulations is not, however, always clear.

Finally, because regulations are not issued all at once, there is a problem of organization. The text of regulations or administrative commentaries is often longer than that of the law. This makes it all the more important to arrange them logically, so that the reader can immediately turn to the relevant portions. Where the law is logically arranged, it makes sense to arrange the regulations in the same way. The method adopted by the United States, whereby the regulations are named according to the section numbers of the statute, makes it easy to find the regulations that correspond to any particular statutory text. The approach of the *Précis de fiscalité*—a treatise summarizing the rules

[50]For example, sec. 19 of the Interpretation Act of Ghana provided "for the purpose of ascertaining the mischief and defect which an enactment was made to cure and as an aid to the construction of the enactment a court may have regard to . . . any memorandum published by authority in reference to the enactment or to the Bill, . . ." *quoted in* Namasivayam, *supra* note 1, at 2.

[51]*E.g.*, LSO IT § 3(2). ("In interpreting this Act, regard should be had to the Explanatory Memorandum accompanying the Act.")

for all the taxes in France—is also user-friendly (it is well organized and has an extensive table of contents and index).

V. Integration

It is important to ensure that a new tax law is fully integrated with the rest of the legal system. Not only does the drafter need to be aware of the obvious issues of possible unconstitutionality, but also more subtle questions of conformity with local drafting style and language as well as the legal system in general need to be considered to enhance the acceptability, understandability, and effectiveness of the law.

A. Local Drafting Style

Apart from general principles of good drafting, tax statutes must be drafted in the context of the style of legislative drafting in the country in question. Different countries have developed their own drafting practices. The officials of some countries may be willing to make changes if convinced that the result would be a better statute. Others may be wedded to their traditions and reluctant to change even if the result would be more efficient or more elegant. There is much to be said for tradition in drafting style. A country's laws should be consistent in appearance and style so as to facilitate understanding and interpretation of the laws and maintain the dignity of the legislative process. Therefore, to draft tax laws differently, the officials responsible for legislative drafting in a country may have to make a more universal change, which might require some persuasion. Those responsible for drafting tax laws must do their best within these constraints. Unless a country's officials decide to make a change in their drafting style, the drafter must follow that style.[52]

B. Gender-Neutral Language

In recent years, there has been increasing awareness of the desirability of using language that does not reflect discrimination based on gender. The issue depends on the grammatical peculiarities of the language in question, as well as on the evolution of the language and its culture. In English, it has become common to avoid exclusive use of the masculine gender to refer to an antecedent of indefinite gender and to avoid nouns denoting a particular gender where an indefinite gender is intended. To the extent called for by the language and

[52]*See* Martineau, *supra* note 1, at 121. In some countries, there is no uniform drafting style; in this case, it may be possible to justify a more modern approach by finding local precedents or by showing that the local style admits to variation.

culture of the country in question, the drafter should take care that usage of words is precise and nondiscriminatory.

C. Relation Between Tax Law and Other Legislation

The context of nontax regulatory and private law is also important for the drafting of tax laws. The tax law must often refer to provisions of economic law, such as the definition of different types of business organization. Accounting norms and principles found outside the tax laws can be critical to their operation.[53] The tax law is fundamentally based on legal relations determined by nontax legislation, primarily private law.[54] If this legislation is nonexistent or is in a confused state, it is difficult to draft a good tax law.[55]

Some nontax regulatory legislation is important for the effective functioning of the tax laws, for example, legislation requiring the registration of company shares and other securities (i.e., prohibiting issuance in bearer form),

[53]*See* vol. 2, ch. 16, appendix.

[54]Mostly in civil law countries, law is generally classified as either public law or private law, the former having to do with the state and the latter governing relations among persons (such as property and family relationships). Private law would include what in common law systems is known as the law of contracts, torts, property, and family law. For a discussion of the distinction between public and private law, *see* 2 International Encyclopedia of Comparative Law, ch. 2, Structure and Divisions of the Law (R. David ed.). For a discussion of the relation between private law and tax law, *see* Sture Bergström, *Private Law and Tax Law*, 23 Scandinavian Studies in Law 31 (1979); 1 Klaus Tipke, Die Steuerrechtsordnung 89–104 (1993).

[55]For example, in several countries of the former Soviet Union, as well as in countries of Eastern Europe, it has not been clear whether certain enterprises are legal persons under civil law. Tax legislation often uses the term "legal person" in defining taxpayers, and any uncertainty about the meaning of the term can therefore lead to difficulties in the implementation of the law. Before the split-up of the Soviet Union, the uncertainty arose in discussions about whether an "enterprise" was of necessity a legal person. *See* M.S. Braginskii, *Legal Regulation of Entrepreneurship in the Russian Federation*, 19 Rev. Central and East Eur. L. 365, 377 (1993). Laws on entrepreneurship were passed with different wordings in various countries. For example, in Latvia the Law on Entrepreneurial Activity (1990) *reprinted in* Joint Publication Research Service, Regional Economic Issues JPRS-UEA-90-043 (Dec. 11, 1990), art. 7, states that "the legal capacity of an enterprise arises at the moment of its registration. . . ." This suggests to some that an enterprise is necessarily a legal person. But the Latvian Law on Partnerships, art. 1, states "a partnership is not a legal entity." The Law on Enterprises in the Republic of Kazakstan (1991, as amended in 1993), *reprinted in* Foreign Investment and Privatisation in Kazakhstan: Collected Legislation 103 (W.E. Butler trans., 1993), art. 1, states "an enterprise is an autonomous subject with the rights of a juridical person. . . ." And further, in art. 5(2): "An enterprise shall be considered to be created and shall acquire the rights of a juridical person from the date of the State registration thereof." Under provisions such as these, the status of partnerships, associations, sole proprietorships, and branches of foreign companies can be unclear or subject to doubt. (The situation may have been clarified in Kazakstan with the adoption of a new civil code in late 1994.) Under such circumstances, it is irresponsible for a drafter of tax legislation to use the term "legal person" as if it were perfectly clear which type of enterprise is a juridical person and which is not. Instead, it may be necessary to fashion a definition of this term, or an alternative term, such as "enterprise," that will apply for tax purposes, pending resolution of the uncertainties in the civil law.

legislation limiting the scope of bank secrecy, legislation governing the integrity of the civil service, and legislation providing effective civil and criminal procedure.

There is a tendency, particularly in civil law countries, for the law to be seen as a consistent whole. Concepts defined by the civil law therefore need not necessarily be redefined in the tax law. One problem arises because a term may not have an unambiguous meaning in the civil law;[56] problems can also arise—whether in a civil or common law system—when a term is defined with reference to its meaning in another statute.[57] There may, however, be a good reason for the meaning of a term for tax purposes to differ from the ordinary meaning. For example, the concept of "employee" may be well defined in the labor law, but the tax definition of an employee may appropriately be broader.[58] Similarly, the tax law may tax as a separate entity an economic unit that does not have independent legal personality under the civil law, or conversely may provide for flow-through treatment of an entity that is a separate person under the civil code. In some cases it is also necessary to disregard the civil law forms chosen by the parties in order to minimize their tax liability.[59] Where it is desired in the tax law to use a term with a broader meaning than in the civil law, there are two alternatives. One is to use the same term as that used in civil law, but to provide a special definition in tax law. For example, the term "employee" can be used in the income tax law, but defined to include persons who are not employees under the civil law. This approach can, however, be confusing, particularly to someone who does not read all the definitions carefully. An alternative is to use a different term in the tax law, where the intended meaning is different from that in the civil law. The disadvantage of this, however, can be that the term used might sound artificial or be cumbersome. Neither approach may be fully satisfactory.

D. Specific Problems of Terminology

Certain terms whose meaning is defined in the civil law are used pervasively in tax laws of different kinds and must be used or defined with care. Some examples follow.

1. *Legal Person*

In most civil law countries, business entities (companies, partnerships of various kinds) are generally legal persons. In countries such as France, Spain, and those with similar civil codes, the various forms of *sociétés* or *sociedades* generally are legal persons. There are, however, some business arrangements

[56]*See, e.g.*, Bergström, *supra* note 54.
[57]*See* Thornton, *supra* note 1, at 110–16.
[58]*See infra* sec. V(D)(2).
[59]*See supra* ch. 2, sec. III(1).

that do not give rise to a legal person and that are characterized by a splitting of the income from the business venture among the parties.[60]

The situation is different in Germany. Under the German civil code, *Personengesellschaften* (partnerships of persons) are not legal persons, while *Kapitalgesellschaften* (capital companies) are legal persons. This distinction in fact may not make very much practical difference for purposes of the civil law for reasons that need not be gone into here.[61] But it means that given the formal distinction, and the fact that *Personengesellschaften* include important forms of commercial partnerships, references in the tax law to "legal persons" will not include *Kommanditgesellschaften* (limited partnerships) or *Offene Handelsgesellschaften* (general partnerships).[62] In Germany and other countries where partnerships are not legal persons,[63] it is necessary, where appropriate, to define taxpayers as including legal persons and certain other entities that are not legal persons.

In some countries, the status of an entity for tax purposes is determined not by the civil law but by the tax law. Thus, in the United States, whether an entity is treated as a corporation is determined by rules under the tax code.[64] A similar problem comes up when the status of a foreign entity is in question. Usually, the determination is made not according to whether the entity has the status of a legal person under the law of its home jurisdiction, but according to what its status would be in the jurisdiction in question. This should be specified.

2. *Employee*

Whether an individual has the status of employee or independent contractor can have importance for tax purposes. In common law countries, the distinction is typically made according to the criteria of common law. This looks to the degree of control that the employer has. In civil law countries, the determination is made according to the status of the relationship generally determined under the labor code.[65] In both civil and common law jurisdictions, employees will not include directors of companies, public officials, and certain other persons whom one would wish to treat as employees for tax purposes. These should also be defined as employees for purposes of the tax law.[66]

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[60] *See, e.g.*, Code civil art. 1871 (FRA) (*société en participation*).

[61] *See* Handelsgesetzbuch arts. 124, 161 (DEU).

[62] *See* DEU KStG § 1(1)(4).

[63] *See* vol. 2, ch. 21.

[64] *See* USA IRC § 7701.

[65] *See, e.g.*, Code du travail art. L 121-1 (FRA).

[66] *See, e.g.*, FRA CGI arts. 80, 80 *ter*. The issue is discussed in greater detail *infra* ch. 11 and in vol. 2, ch. 14.

3. *Property*

Legal systems differ in their concepts and classification of property.[67] Usually, different kinds of property do not need to be defined separately in the tax laws because their meaning will be given in the civil law. But care should be taken. "Real" property (in common law jurisdictions) has a similar but not identical meaning to "immovable" property in civil law jurisdictions. Some civil codes have peculiarities. For example, the Russian civil code defines immovable property as including airplanes and businesses.[68] In such cases, it may be necessary to separately define immovable property in the tax laws as excluding this type of property.[69] Similar care should be taken in using concepts such as tangible property, intangible property, and fixed assets. In countries with codified accounting norms, categories of assets and liabilities relevant for tax purposes are often defined in these norms.

E. Use of Models

Recent years have seen the publication of the *Basic World Tax Code*, authored by two American lawyers who have also worked extensively abroad, and the Draft of a Tax Code for Middle and Eastern European States, authored by a German tax professor and commissioned by the German Ministry of Finance.[70] A model tax code (general tax law) was published in the 1960s, intended primarily for Latin American countries.[71] Other unpublished model tax laws are in various stages of development. The IMF's Legal Department has prepared a number of draft model laws for use in its technical assistance work; these are revised on an ongoing basis as experience with them suggests improvements. Some of this model legislation is geared to a particular country or legal or linguistic tradition; some is intended to be used on a wider basis.

Model legislation is extremely useful as a starting point for drafting. Given the complexity of tax legislation and the wealth of experience with tax laws in many countries, it would be foolish for a drafter to attempt to reinvent the wheel. On the other hand, the complexity of the laws of countries with well-developed tax systems is so great that it is inappropriate to use them as a model without a considerable degree of pruning and revision. The various

[67]For a historical introduction, *see* Boudewijn Bouckaert, *What Is Property?* 13 Harv. J. L. & Publ. Pol'y 775 (1990); 1 Vinding Kruse, The Right of Property (1939).

[68]Civil code arts. 130(1), 132 (RUS); civil code arts. 117, 119 (KAZ).

[69]E.g., KAZ TC art. 5(16).

[70]Ward Hussey & Donald Lubick, Basic World Tax Code and Commentary: 1996 Edition (1995); Joachim Lang, Entwurf eines Steuergesetzbuchs für mittel- und osteuropäische Staaten (Bundesministerium der Finanzen 1992).

[71]Organization of American States, Modelo de Código Tributario (1967). In addition, the Inter-American Center of Tax Administrators has planned to publish a model tax code in 1996.

model tax laws tend to be derived from the legislation of particular countries, although a considerable amount of distillation may have taken place.

Proper use of a model in drafting legislation for a specific country involves the realization that considerable adaptation, if not wholesale revision, of the language of the model will likely be required in order to meet the particular needs of the country in question. A model can only be a starting point. As long as the limitations of any model are borne in mind, a model can be a useful, even essential, tool in drafting.

4

Law of Tax Administration and Procedure

Richard K. Gordon

> The Ruler should act like a bee which collects honey without causing pain to the plant.
>
> —*Mahabharata*

Tax administration law covers an enormous number of issues. An essay that attempted to cover each issue in detail would run on for volumes, rather than pages. To keep the discussion at a reasonable length, this chapter offers only an introduction to some of the issues involved. Where there is little theoretical controversy, the chapter only outlines the issues and provides discussion of a basic nature.

The result is a chapter that, like Gaul, is divided into three parts. The first part consists of a relatively general discussion of the nature of the law of tax administration and procedure and how it relates to other laws.

The second part consists primarily of a checklist of those elements that should be included in a tax administration law, except for matters concerning tax compliance, which are covered in the third part. The discussion in the second part is more limited, primarily because, at least concerning most of these points, there is little debate of a theoretical nature that would profit by additional exposition here. This checklist offers an introduction to the fundamental mechanics of the law for those who might not be completely familiar with tax procedure.

The third part discusses compliance. It begins by discussing how substantive tax laws should be drafted to further compliance goals and then addresses the question of taxpayer sanctions, how they work, and what is required to

Note: Victor Thuronyi, Melinda Milenkovich, Milka Casanegra de Jantscher, U.I. Dharmawansa, V.S. Rekhi, Reinier Kraakman, Ward Hussey, Leif Mutén, and Pamela Sak each provided extremely helpful comments and corrections.

make them effective. Much of the current research into sanctions has suggested some counterintuitive conclusions, which are often largely at odds with sanctions extant in many tax laws. For this reason, this part includes a relatively detailed discussion of these issues.

I. Structure of Tax Administration Law

A. Organizing Principles of Tax Administration Law

It is a frequently heard complaint that tax administration laws are complex, confusing, and arbitrary. To some degree this is probably unavoidable. Administration of a tax system must cover an enormous and diverse number of rules. Unlike the substantive laws of taxation, there is no basic "principle" of administration. In contrast, an income tax law, a property tax law, or a value-added tax (VAT) law each has unifying themes. While each may include some complex definitions, simplifications, or exceptions to these themes, there are at least a limited number of principles, typically related, around which the law can be structured and to which both policy analysts and drafters can return when creating the law.

In contrast, it is not easy to encapsule a few guiding themes for a tax administration law. There are a number of very broad principles that should apply in each administrative rule, such as fairness and efficiency, but these do not really help much in guiding substantive design. In some ways, tax administration law is constituted by a hotchpotch of rules, some related, some not very closely related, some expressing clear policy, and some based rather largely on arbitrary considerations. This is due to the fact that tax administration law is first and foremost the elucidation of a bureaucracy. Public administration, in and of itself, is not easily determined by reference to a small number of principles. Instead, it is much more a question of designing acceptable answers for myriad practical bureaucratic problems.[1]

Nevertheless, some order can be brought to the organization of tax administration law. Three organizing principles can be identified: organization according to function, temporal organization, and organization by legal category. In combination, the three can make for a coherent legal structure that corresponds to the bureaucracy and procedure with which the tax administration law deals.

1. *Functional Categories*

It is not surprising that the most important way in which the better tax administration laws are organized mirrors the way in which tax authorities

[1]Interestingly enough, Freud described the borderline between psychosis and neurosis as when the mind acts like a bureaucracy. Sigmund Freud, An Outline of Psychoanalysis 48 (1911).

themselves are, or at least should be, organized. In other words, the laws are primarily organized around the different bureaucratic functions necessary for the administration of a tax system. For this reason, this essay will refer to this form of organization as "functional."[2] Sections in tax administration laws corresponding to functional categories cover regulations and rulings, record keeping and returns, audits and investigations, dispute settlement, recovery of monies owed to the government, internal investigations, and taxpayer ombudsperson.[3]

Functional organization of tax administration law makes it easier for the taxation authority, as well as for other government officials involved in the taxation process, to follow and interpret the law. Each department in the taxation authority can concentrate primarily on a single part or parts of the law.[4] Of equal importance, while organizing by function may initially appear to reflect the world of tax administration from the viewpoint of the bureaucracy, so doing automatically reflects administration from the taxpayer's perspective as well. The taxpayer's involvement in each aspect of tax administration can largely be described by his or her interaction with different departments of the taxation authority. Therefore, organizing tax administration law in functional groups also helps the taxpayer better understand the rules and the process.

2. *Temporal Organization*

The quality of making the law easier to understand for the taxpayer as well as for the administration can be accentuated if the functional categories are themselves organized so that they follow in logical, temporal sequence. Temporal organization for the law of tax procedure makes sense because tax procedure inevitably follows a time sequence, given that each tax obligation is based on a tax period, with a subsequent possibility of the redetermination of tax, appeal of the redetermination, and ultimate determination of tax liability

[2]For a tax administration, the opposite of functional organization is organization according to substantive taxes. While many tax administrations are organized in this way, the general trend is toward a functional organization. *See* Aldo Schlemenson, *Organizational Structure and Human Resources in Tax Administration*, *in* Improving Tax Administration in Developing Countries 343 (Richard M. Bird & Milka Casanegra de Jantscher eds., 1992). *See also* Richard M. Bird & Milka Casanegra de Jantscher, *The Reform of Tax Administration*, *in id.* 1, 9.

[3]For example, The United Kingdom's Taxes Management Act includes statutory subdivisions on returns, assessment and claims, dispute settlement, recovery of monies owed, and penalties for tax offenses. *See* GBR TMA §§ 7–12, 29–43, 48–56, 60–70, 93–106. The U.S. Code, in Subtitle F on procedure and administration, includes sections on returns, assessment, collection, dispute resolution, tax offenses and penalties, and taxpayer ombudsperson. *See* USA IRC §§ 6001–7873. Belgium's code includes sections on returns, audits and investigation, assessment, dispute settlement, and penalties. *See* BEL CIR arts. 297–463.

[4]An additional functional category sometimes found in tax administration laws, one that forms the necessary precursor to the creation of the administrative bureaucracy, provides for the creation of the tax administration itself. However, in some jurisdictions the rules concerning the creation of departments or administrative authorities may be found in a separate law. *See, e.g.*, DEU FVG.

for the period. A temporal organization would mean that the law should begin with those rules concerning the elucidation of the law (regulations and rulings), followed by the incurring of a liability by a taxpayer (which would typically require the taxpayer to secure an identification number, keep records, and file returns), and then continue through each step through remittance of tax (or information), enduring an audit, disputing the assessment decision, and suffering a collection action. While not every taxpayer would be involved in each possible step in administration, both taxpayers and administrators would know to skip over intervening possibilities until the next relevant issue was reached. In the process, both would be reminded of those possibilities.

3. *Legal Categories*

Some rules, which represent a common legal category, cut across both functional and temporal lines. They cannot easily be organized on a temporal basis because they apply at a number of possible temporal steps. These are best placed together, usually at the beginning and the end of a tax administration law. Among the most important of these categories are definitions that apply to terms found generally throughout the law, the legal rights of taxpayers,[5] penalties (both civil and criminal) for a taxpayer's failure to comply with his or her obligations, penalties for a failure on the part of the administration to comply with its obligations, and interest (due both to government on underpayment and the taxpayer on overpayment).[6]

There is no organizational imperative to collect the relevant rules in such categories separate and apart from functional divisions. For example, every right, as well as each liability for any penalty or interest, whether relating to taxpayers or to the administration, with few exceptions arises only in the context of a rule described in a functional category. In the broadest sense, the rights of a taxpayer can be understood to include not only what is normally thought of as "rights" (e.g., the right to secrecy, the right to representation), but also essentially everything that is not specifically required of him or her (e.g., the right *not* to keep unnecessary records, or the right *not* to have a levy enforced on him or her for monies not lawfully due). Similarly, both penalties and interest, whether owed by taxpayer or government, can be understood to arise wherever among the rules in the functional categories the obligation arises (e.g., a penalty for failure to keep records, a penalty for requiring the taxpayer to keep unnecessary records, a penalty for failure to submit to a lawful levy, or a penalty for forcing submission to an unlawful one, and interest due on any underpayment or overpayment).

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[5]*See* the discussion of who or what constitutes a taxpayer, *infra* sec. II(B).

[6]*See, e.g.*, KAZ TC arts. 142, 161–63 (articles regarding taxpayer rights, penalties for overdue tax payments, fines for late filing of returns, penalty for understatement of taxes, current payments, and objects of taxation); FRA CGI arts. 1725–56 *septies* (articles regarding penalties); GBR TMA §§ 86–106 (sections on interest on overdue tax and tax penalties).

There are important benefits to collecting certain general definitions, taxpayer rights, interest, and penalties in separate categories. By and large, the rights, interest, and penalties included in separate categories are those that are broadly applicable throughout much or all of the administrative process. Therefore, rather than repeating each, it is easier to put them in one place and to make clear that they refer to more than one aspect of the administration law. There are also general rules applicable to all penalties (e.g., a reasonable cause exception) that can usefully be grouped with the specific penalty rules. Also, placing certain definitions, taxpayer rights, interest, and penalties into separate sections makes it more likely that the design and therefore the application of each will be more uniform.

B. Interrelation of Tax Administration Law with Other Laws

1. *Nontax Law*

Tax administration law is intimately connected with various laws (including the state constitution) not specific to taxation. For example, laws concerning the operation of the executive branch may affect the structure and function of the tax administration.[7] Administrative law may affect how regulations and rulings are issued.[8] The civil procedure code may have considerable relevance to numerous aspects of tax administration, including rights to notice of government action, rights to counsel during proceedings, procedures for dispute settlement in civil courts (including the application of civil fines and of appeals), and rules concerning the recovery of debts.[9] Criminal procedure rules typically govern the application of criminal penalties in the tax area.[10]

As a general rule, unless there is a specific and compelling reason, it is probably best not to provide special rules only for tax matters. William of Occam, the great fourteenth-century English natural philosopher, admonished "[d]o not multiply entities unnecessarily."[11] To do so makes things more complicated than they need to be. Where rules relevant to tax procedure are contained in other laws, it may be beneficial to make cross-references to these laws in the text of the tax administration law. In certain cases it may be preferable to modify existing law to fit the unique problems inherent in tax administration. Where possible, it is probably best to make clear what nontax

[7]*See, e.g.*, Grundgesetz arts. 104a–115 (DEU) [hereinafter GG]; 5 U.S.C. §§101–306 (USA).

[8]*See, e.g.*, the Administrative Procedure Act, 5 U.S.C. §§ 551–83 (USA) [hereinafter APA]; and the Verwaltungsverfahrensgesetz (DEU).

[9]*See, e.g.*, Code of Civil Procedure §§ 166–213a, 511–44, 803–71 (DEU) (procedure for service of process, appeals, and execution levied on movable property and real property); Code of Civil Procedure arts. 411–20, 542–60, 651–94 (FRA) (procedure regarding representation, notice, and appeals).

[10]*See infra* sec. III(C)(6).

[11]William of Occam, *Quodlibeta Septem* (1320), *quoted in* John Bartlett, Familiar Quotations 143 (15th ed. 1980). This is the original statement of Occam's Razor.

rule is being modified, and to limit the modification to the minimum necessary to effect the specific tax administration purpose.[12]

2. *Substantive Tax Law*

There is no clear line separating substantive tax law and tax administration law. There are a number of ways of drawing a line, however. One would be to include in the law of administration any rule that is primarily administrative in nature. Another would be to put into each substantive tax law the administrative rules that are peculiar to that tax, and to put in the general administrative law any rule that applies to more than one type of tax. Most jurisdictions apply a mix of both.[13]

3. *Location of Tax Administration Law*

The practice of countries differs greatly in terms of where the tax administration provisions are located. In some countries, each substantive tax law contains all the provisions necessary for its administration. In countries that organize all their tax laws into one code, the tax administration provisions can be one or more titles of this code. Yet other countries have what may be called a tax administration law or a general law on taxation. The tax administration provisions may also be contained in more than one law. For example, there may be a law on the tax system, which contains many of the general rules of procedure, and a law on the state tax service, which primarily governs the organization of the state tax service, but also deals with some of its powers as against the taxpayer.[14] The last approach can be confusing, particularly if the same matters are dealt with in both laws.[15]

II. Matters to Be Included in a Tax Administration Law

A. Compilation and Publication of All Tax Laws

All legislation concerning taxation, including tax laws, regulations, administrative interpretations, and court decisions, should be compiled and generally made available. Unless this issue is already covered elsewhere, the law

[12]Examples of such provisions are included in the tax laws of the United States, France, and Germany; these codes include sections regarding tax liens and seizure of the taxpayer's property. *See* USA IRC §§ 6321–27, 6331–44; FRA CGI arts. 1920–29 *septies*; DEU AO §§ 281–308.

[13]For instance, in Australia provisions regarding returns and assessments are contained in the Income Tax Assessment Act, while in the United Kingdom such provisions are included in the Taxes Management Act. See AUS ITAA §§161–77; GBR TMA §§ 7–18, 29–40. Provisions regarding assessment are also contained in Germany's income tax law. *See* DEU EStG §§ 25–28.

[14]*E.g.*, RUS TS; RUS STS.

[15]In Australia, for example, the Taxation Administration Act 1953 and the Crimes (Taxation Offenses) Act 1980 both concern themselves with tax offenses. *See* AUS TAA §§ 8B–8Z; AUS CTO.

on tax administration and procedure should so require. The greater the availability of such information, the easier it is for taxpayers, tax administrators, and adjudicators to research the law and to make sure that they have uncovered all the relevant information on any particular subject.

B. Definitions of General Applicability

There is considerable difference among different legal traditions as to the desirability of definition sections in statutes or as to their appropriate scope. For example, legislation based on the U.K. tradition often includes monumental definition sections, while statutes based on the French civil code tradition often have no definition sections at all.[16] However, where appropriate to the particular legislative tradition, definitions of general applicability can be of considerable use to avoid confusion in interpreting the law.

Among the most important definitions is that of "taxpayer." Any reference to a taxpayer in a law on administration and procedure should, unless otherwise indicated, include any physical or legal person who is required under the tax administration laws to collect or remit tax (plus any related interest or penalties) or information. The definition of taxpayer would, therefore, include both third-party withholding agents and those physical persons who are responsible for effecting the collection or remission of tax or information owed by legal persons. An acceptable alternative, which is followed by some laws, is to make a terminological distinction between taxpayers and such persons as withholding agents, who are responsible for paying the taxes of another.[17] If such a distinction is made, then care should be taken to draft the law so that both taxpayers and responsible persons are subject to the relevant procedural requirements of the law.

Which other definitions might be included in a definition section would depend on the particular legal terminology in use in the particular jurisdiction. Some examples are discussed in chapter 3, section V(D).

C. Regulations and Rulings

In many jurisdictions, administrative regulations and rulings are an important instrument for interpreting tax law. Depending on the jurisdiction and its legal traditions, rulings can be of general application or can apply only to

[16]*See* GBR ICTA § 831 *et seq.*; AUS ITAA § 6 *et seq.*; FRA CGI; CIV CGI.

[17]*See, e.g.*, VEN COT §§ 19–29. French tax law draws a distinction between a *contribuable* (taxpayer) and a *redevable*. The former is the person in whose name the tax obligation is legally established; the latter is a person from whom the law may authorize the tax authorities to require payment of the tax obligation (e.g., a withholding agent or a person jointly liable for payment of the tax). *See* Gilbert Tixier & Guy Gest, Droit fiscal 222–23 (3rd ed. 1981). Confusingly, however, the term *redevable* is also used in a meaning synonymous with that of "taxpayer," in the cases of taxes such as the VAT, the wealth tax, and the *taxe professionelle*. *See* Précis de fiscalité ¶¶ 2000, 4890, 6176 (1994); FRA CGI Titre II, ch. I, sec. VI (*Redevables de la taxe*).

specific taxpayers, and they can apply prospectively or retrospectively. In the case of rulings of specific application, they can be issued in advance of a transaction or following the transaction. The treatment of these matters in a number of jurisdictions is discussed in chapter 2, sections VI(D) and (E). What follows is an outline of what might be considered appropriate to include in a tax administration law in a typical jurisdiction.

1. *Regulations and Rulings of General Applicability*

The government should solicit outside comment and obtain a broad range of opinion by holding public hearings on proposed regulations. Persons can testify orally or submit written testimony. The opportunity for all parties to be heard will assist the government in uncovering beforehand any unintended benefits or hardships its proposed action will produce. Hearings are required in some countries by a law on administrative procedure.[18] In the absence of a similar law, the matter can be addressed specifically by the tax administration law.

In general, the tax authority should be bound by its regulations and rulings of general applicability. Of course, the tax authority must be permitted to reverse a position when necessary, but this should normally be done only on a prospective basis.[19]

2. *Rulings of Specific Application*

Although the legal traditions of some jurisdictions restrict their use, there is considerable benefit to having a procedure whereby rulings of specific application may be issued at the request of a taxpayer.[20] These rulings are typically based on fact patterns presented to the taxation authority.[21] In jurisdictions such as the United States, such rulings are limited only to the taxpayer in question and cannot be used as precedent by any other taxpayer.[22] To ensure accuracy and fairness in rulings, all rulings should probably be approved by a central rulings office or by another appropriate higher-level authority.[23]

The authority to issue legally binding rulings should be specified in the law, and the procedure specified either in the law or in delegated legislation.

[18]For example, in the United States, the Administrative Procedure Act [APA] applies to any "authority of the Government of the United States" that is not Congress, the courts, or a military authority. 5 U.S.C. § 551(1) (USA). Under the APA, the Treasury Department may issue regulations and rulings relating to internal revenue laws only after publication of a notice of proposed rule making, followed by public hearings. *Id.* § 553. A failure to comply would result in the regulation being invalid. *See* American Standard, Inc. v. United States, 602 F.2d 256 (Ct. Cl. 1979).

[19]For further discussion of this issue, *see supra* ch. 2, sec. (IV)(D).

[20]*See, e.g.*, Treas. Reg. § 601.210(a), (e) (as amended in 1983) (USA). *See also* ch. 2, sec. IV(E).

[21]*See* Treas. Reg. § 601.201(a)(2) (USA).

[22]*See id.* § 601.201(l).

[23]*See, e.g., id.* § 601.201(a)(2).

D. Returns and Record Keeping

1. *Returns*

With respect to income tax and some other taxes, many jurisdictions have systems where the taxation authority assesses the amount of tax due based on information provided to it, usually by the taxpayer. However, efficiency concerns are increasingly motivating jurisdictions to adopt self-assessment systems, where the taxpayer determines tax owed. With regard to income taxes, self-assessment systems do not necessarily require that each individual prepare a return and determine tax owed, as several types of income can be taxed through final withholding taxes. If some taxpayers, say, small businesses, cannot currently be relied upon to determine their own tax, self-assessment for income tax can be introduced in stages, starting with larger enterprises and extended to others as they gain the necessary skills.

Whether a self-assessment system is in effect or not, the taxpayer must provide essential information to the taxation authority in the tax return so that it can either determine the amount of tax owed or check on the taxpayer's calculations.

Tax returns must spell out in detail the information required of the taxpayer. In a self-assessment system, the information will be in the form of a series of steps that the taxpayer must undertake in calculating the tax. The accompanying instructions to the return should provide comprehensive guidelines for filling out the return, taking the taxpayer logically from one line of the form to the next.

The general rules relating to returns (e.g., who is required to sign the return and procedures for extending the time to file) can be contained in the general tax administration law.[24] The specific tax laws should specify the deadline for filing and who is required to file.[25]

2. *Information Returns*

An information return is a declaration by a person who, though not necessarily liable to withhold tax, has economic information about one or more potential taxpayers.[26] The law must give broad powers to the tax administration to establish a filing requirement for information returns and to define the format to be used.[27]

3. *Conditioning a Tax Benefit on Identification of the Payee*

The law could require that in order to obtain certain tax deductions or credits that are triggered by a payment, a taxpayer must identify the payee. By

[24]*See, e.g.*, DEU AO §§ 149–53.

[25]*See, e.g.*, DEU EStG §§ 25, 1; DEU KStG § 49.

[26]*See, e.g.*, USA IRC §§ 6041, 6041A, 6042, 6044, 6045, 6049.

[27]*See id.*

identifying the payee, the taxpayer provides the tax administration with valuable information that can be used in auditing the payee. Because it relates to the determination of the tax base for a specific tax, this type of rule is generally included in the specific tax laws.[28]

4. *Record Keeping*

The law or regulations should specify taxpayers' obligations to keep books of account and other records necessary for determining tax liability.[29] These would include the content and form of invoices, what taxpayers must use them, and under what circumstances.

E. Audits and Investigations

1. *Relationship Between the Taxation Authority and Investigative Agencies*

Many, if not most, jurisdictions have found it appropriate to segregate the civil functions of tax administration from the enforcement of criminal law, so that procedural protections for citizens are not undermined. The tax administration should not, for the purpose of civil tax investigations, rely on search powers given to the police. The tax administration's search powers should be specified in the tax administration law, subject to constitutional constraints.[30]

It is common for countries to provide a separation between the functions of civil and criminal investigation. Once the tax authorities have determined that there appears to be sufficient evidence of criminal behavior, the case should be turned over to the public prosecutor, and the procedures for criminal investigation should be applied from that point on.

2. *Access to Third-Party Records and the Power to Issue Summonses*

The tax administration should have access to the records of anyone who has financial dealings with taxpayers and who can provide relevant information on taxpayers' income and the accuracy of their tax declarations and books and records.[31]

3. *Indirect Methods of Assessment*

The law should specifically authorize the tax administration to use alternative methods to establish or verify the amount due, whether the tax in-

[28]For example, a VAT input credit is typically allowed only if the taxpayer has an invoice from the supplier.

[29]*See, e.g.*, USA IRC § 6001; CAN ITA § 230; DEU AO §§ 140–48.

[30]*See, e.g.*, USA IRC § 7608; GBR TMA § 20C; CAN ITA § 231.3.

[31]*See, e.g.*, USA IRC § 7609; CAN ITA § 231.2.

volved is income, VAT, or another tax.[32] The taxation authority should be permitted to use these alternative forms whenever the taxpayer fails to provide the records otherwise required in a complete and accurate form.

F. Dispute Settlement

1. *Compromises*

To further efficiency, throughout the dispute-settlement process the tax authority should be allowed discretion to settle issues of controversy with the taxpayer.[33] The tax authority should consider the likelihood that the authority would prevail in an adjudication and the costs of pursuing the authority's position. The authority should also have the discretion to reduce civil penalties, but not interest due.

2. *Payment of Tax During Dispute*

Countries differ on whether taxpayers are required to pay any tax subject to dispute in order to pursue a dispute.[34] Some consider it unfair to impose such a requirement. Others impose it to discourage frivolous disputes. An intermediate position would be to allow tax authorities or the court to waive the requirement on a case-by-case basis. Another possibility is to require payment of a portion of the tax (e.g., 50 percent).

3. *Disputes Within the Taxation Authority*

Disputes between tax authority and taxpayer must be resolved in as fair, timely, and efficient a manner as possible. A single method of resolving disputes, from registration of taxpayer disagreement with an assessment up to resolution of a final appeal, is preferable.

The first forum for dispute settlement should be with the taxation authority officials who first issued the assessment. The taxpayer should be given the opportunity, within a limited prescribed time, to disagree with the assessment, either in writing, in person, or both.[35] If the assessing official or officials agree

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[32] *See infra* ch. 12.

[33] For example, U.S. law permits the Internal Revenue Service (IRS) to "compromise any civil or criminal case arising under the internal revenue laws prior to reference to the Department of Justice for prosecution or defense." USA IRC § 7122; *see also* Treas. Reg. § 301.7122-1 (as amended in 1960) (USA).

[34] In the United Kingdom, France, and Germany, payment may be suspended when the assessment is under appeal, while in Italy suspension of payment is not permitted. Organization for Economic Cooperation and Development, Taxpayers' Rights and Obligations: A Survey of the Legal Situation in OECD Countries 99 (1990).

[35] In the United Kingdom, the taxpayer may, in writing, appeal a tax assessment within 30 days after the date of notice of the assessment. GBR TMA § 31.

with the taxpayer on any point, a new assessment can be issued.[36] This assessment should be reviewed by a superior official.

If a dispute continues, the taxpayer should have the opportunity, within a prescribed period of time, to appeal to a special administrative appeals board. To ensure impartiality, this unit should be completely independent of other divisions of the taxation authority. It could report to someone outside of the tax administration authority, perhaps the general counsel (chief lawyer) of the finance ministry.[37]

4. *Tax Adjudications*

If agreement is not reached, the taxpayer should have the opportunity, within a prescribed period of time, to appeal to a court. Some jurisdictions allow appeal to the ordinary courts. These are typically not well suited to adjudicate tax matters, so consideration should be given to establishing a special tax court.[38] Depending on the legal traditions of the jurisdiction, this tax court can be set up inside or outside the regular court system. Also depending on the particular legal traditions of the jurisdiction, judges on the court might include both tax professionals and laypersons. The tax court would then hear evidence from both the taxpayer and the tax administration and would reach a decision in a trial-like setting. However, the regular rules of evidence need not necessarily be applicable to the tax court. In addition, experts other than lawyers or advocates, such as accountants, might be permitted to represent taxpayers before the tax court.[39]

In some jurisdictions, appeal is to a court specializing in appeals from administrative decisions, although not specializing in tax cases.[40]

Both the taxpayer and the tax administration should be permitted to appeal a decision of the tax court, ordinary court, or administrative court to a court of appeal.[41] Such appeals should be based only, or at least primarily, on matters of law, not of fact.

5. *Procedures in Tax Adjudications*

An adjudicative proceeding should minimize surprise and give taxpayers every opportunity to know of and rebut the case against them. First, each party

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[36]*See id.* § 32.

[37]*See infra* sec. II(K)(9) concerning taxpayer rights to appeal.

[38]*See, e.g.*, USA IRC §§ 7441–75.

[39]*See id.* § 7452; *see also infra* ch. 5.

[40]For example, in France, general principles of administrative law require that the legality of an administrative decision can always be reviewed by an administrative judge. *See* Judgment of Feb. 7, 1947, Conseil d'Etat, 1947 Recueil des arrêts du Conseil d'Etat [Lebon], No. 79128, at 50. Such decisions are then themselves appealable to the Conseil d'Etat. *See* Judgment of Oct. 19, 1962 Conseil d'Etat, 1962 Lebon, No. 58502, at 552.

[41]*See, e.g.*, *id. See also* USA IRC § 7482.

should fully inform the other regarding the issues being contested.[42] Both parties should exchange all relevant documents within an adequate time period before the adjudication.

Depending on the jurisdiction, rules of discovery may vary depending on the stage of adjudication and the nature of the particular forum. For example, in the United States, discovery rules vary depending on whether the case is before an administrative officer at the Internal Revenue Service, the Tax Court, the Court of Claims, or the District Court. At the administrative level, the general disclosure provisions of the Administrative Procedure Act allow the taxpayer to request information in his or her file, unless that information falls within a number of exceptions, including internal communications and information relating to a law enforcement action.[43] Discovery is more limited in the Tax Court than in the Claims Court, and more limited in the Claims Court than in the District Court, each of which has its own rules of procedure.[44] The Administrative Procedure Act also entitles the taxpayer to a copy of any testimony given during the case.[45] Absent fraud or an attempt to conceal, any document not exchanged within this time period should be barred from consideration during the procedure.

6. *Burden of Proof in Tax Adjudications*

In an administrative or judicial proceeding that involves a civil tax issue, the taxpayer should generally have the burden of proof. In some jurisdictions, as a general matter the burden of proof lies with the party normally in possession of the relevant evidence.[46] In tax matters, this party is typically, but not always, the taxpayer. For example, the tax department would have the burden of proof in matters such as comparable gross profits ratios. However, it may be preferable to state explicitly that the burden lies with the taxpayer, except in such instances where the tax department has sole access to the necessary evidence. Absent such

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[42]For example, in the United States, a written report [called a Revenue Agent's Report or RAR] concerning the proposed changes to the taxpayer's return, including explanations, is prepared after each examination. *See* Internal Revenue Manual 4237, Report Writing Guide for Income Tax Examining Officers § 231, MT 4237-17 (Apr. 23, 1987) (Basic Report), *cited in* Michael I. Saltzman, IRS Practice and Procedure ¶ 8.06[8] n.121 (2nd. ed. 1991). Such a report is beneficial to both the taxpayer and the tax administration. If the case is not settled, the Appeals Office prepares a memorandum discussing its decision. *Id.* ¶ 9.05[3]. The taxpayer may obtain a copy of this memo under the Freedom of Information Act. *Id.* n.5.

[43]*See* 5 U.S.C. § 552(b)(5), (b)(7) (USA).

[44]*See* Tax Ct. R. Prac. & Proc. 70(a)(1) (USA); Cl. Ct. R. 26 (USA); Fed. R. Civ. P. 26 (USA).

[45]5 U.S.C. § 555(c) (USA).

[46]For example, under French administrative law, each party must prove its case based upon the materials available on file with the court. However, a failure to reply, whether to the rapporteur or to the tax authority, allows the court to draw the inference that the party in default has no case to make in answer to the question. The effect is that the burden of proof shifts to the party who has the materials. *See* Judgment of May 28, 1954, Conseil d'Etat, 1954 Lebon, Nos. 28238, 28493, 28524, 30237, 30256, at 308.

instances, there should also be a presumption that an assessment issued by the tax department is correct. The taxpayer then has the burden of rebutting this presumption by demonstrating the inaccuracy of the assessment.[47]

G. Recovery

A basic choice must be made as to whether tax debts are to be collected under the same procedures as for all other debts against the government, or for civil judgments generally, or whether special rules should apply in the tax area. Whatever the decision, some reference may be made to nontax laws, such as the civil procedure code, the civil code, or other laws governing the sale of property in satisfaction of a judgment, and some of the provisions described below may not in all cases need to be repeated in the tax laws.

1. *Tax Liens*

The law should provide that a tax assessment is a charge or lien that constitutes a security interest in the taxpayer's property in favor of the government. The lien should be against all property and rights to property, whether movable or immovable, belonging to the taxpayer as of the date of assessment or subsequently acquired during the existence of the lien.[48]

2. *Seizure of Property*

In the case of taxpayers who fail to pay, the law should provide for the seizure of property so that the proceeds from the sale can be applied to their tax liability.[49]

3. *Sale of Seized Property*

With the exception of negotiable instruments such as currency or marketable securities, the law should require seized property to be sold at public auction.[50]

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[47]For example, in the United States, under the decision of the Supreme Court in Welch v. Helvering, 290 U.S. 111, 115 (1933), the assessment of the Internal Revenue Service is presumed to be correct. Rule 301 of the Federal Rules of Evidence states that "in all civil actions . . . a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption. . . ." The taxpayer has the burden of proving the assessment wrong. Helvering v. Taylor, 293 U.S. 507, 514 (1935).

[48]*See, e.g.*, USA IRC § 6321.

[49]*See, e.g.*, GBR TMA § 61; DEU AO § 281.

[50]For example, in the United Kingdom, if the taxpayer does not pay the sum due within five days of the seizure of property, the seized property will be sold at public auction to pay sums owed. GBR TMA § 61(4), (5). Provisions for public auction of seized property are also contained in the tax laws of Germany and the United States. *See* DEU AO § 298; USA IRC §§ 6335, 6336.

4. *Recovery of Debts Owed the Taxpayer by Third Parties*

The law should allow the government to reach persons who might owe money to the delinquent taxpayer, such as employers or creditors.[51] The law should provide for the seizure of such property through a notice of seizure upon the third party and a requirement that the third party pay over to the government the amount owed to the taxpayer.

5. *Installment Payment Arrangements*

The law should authorize the tax authorities to enter into an agreement with a taxpayer, which would allow the taxpayer to pay the tax over time, in cases where the taxpayer cannot pay the amount of assessed tax immediately.[52] The extension of time to pay the tax should not affect the accrual of interest on unpaid amounts.

6. *Receivership*

If it is necessary to seize a business for nonpayment of tax, the tax administration should have the right to ask the court to appoint a receiver for the purpose of administering the business and paying the taxes.

7. *Property Transferred Without Full Consideration*

The government should be given a security interest in any property that was fraudulently conveyed for less than fair consideration. Such provisions are often found in civil or commercial codes and apply generally to all creditors.[53]

8. *Compromise and Write-Offs*

The law should permit tax officials to write off uncollectible accounts and to enter into a compromise with a taxpayer whereby part of the tax liability is canceled.[54]

H. Internal Investigations

Provisions should be made in the law for an internal investigations department within the tax administration. The goal of this department should

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[51] *See, e.g.*, DEU AO § 309.

[52] For example, the U.S. Code authorizes the IRS to enter into a written agreement with the taxpayer allowing the taxpayer to make payment in installments if such agreement would facilitate collection of the tax owed. USA IRC § 6159. *See also* GBR ICTA § 5(2), which in certain cases permits the taxpayer to satisfy his or her tax liability in two equal installments.

[53] *See, e.g.*, Code of Civil Procedure art. 1167 (FRA); Mass. Ann. Laws ch. 109A (Law. Co-op. 1995); Bankruptcy Code, 11 U.S.C. § 548 (USA).

[54] *See, e.g.*, USA IRC § 7122.

be to ensure that the tax authority acts fairly and honestly. The internal investigations department could, like the administrative appeals board, report to someone outside the tax administration authority, perhaps the general counsel of the finance ministry.

I. Taxpayer Ombudsperson

Some countries have established a department of the taxpayer ombudsperson. The role of the ombudsperson would be to assist taxpayers in solving complaints about the tax authority.[55] Although this department could be set up within the tax authority, in order to ensure that it is not overly influenced by other personnel in the authority, it should perhaps report directly to the authority's head.

J. Interest

Interest must be assessed on every late payment of tax[56] or penalty,[57] as well as on every payment due from the treasury to the taxpayer. It should be stressed that interest is not the same as a penalty due for noncompliance. Interest reflects the time value of money and should therefore never be waived or subject to compromise. An interest rate that reflects the full cost of money, including inflation, should be specified, typically by reference to the central bank discount rate, a rate on treasury obligations, or the like.[58] To discourage "borrowing from the government," and to encourage the settling of disputes, the interest rate should exceed the basic rate given debtors in the economy. In part because the government is presumably a better credit risk than a defaulting taxpayer, it may be appropriate to provide a lower rate of interest on overpayments than on underpayments.[59]

K. Taxpayer Rights

Provisions guaranteeing procedural protections to taxpayers can be gathered into a separate section of the tax administration law, or included in the appropriate places in a law organized on temporal or functional

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[55]Countries with an office of ombudsperson include Australia, Austria, Denmark, France, and the United States; Canada, Germany, Italy, and Japan are among the countries without an ombudsperson. *See* OECD, *supra* note 34, at 20, 76–77. *See also* USA IRC § 7811.

[56]*See generally* DEU AO §§ 233–39 (provisions regarding assessment of interest, including when interest payments are assessed and how they are calculated).

[57]*See* USA IRC § 6601(e).

[58]For example, in the United States, the rate is determined using the rate on treasury obligations. *See id.* §§ 6621, 1274(d).

[59]For example, in the United States the overpayment rate bears an interest rate 1 percentage point lower than the underpayment rate. *Id.* § 6621(a)(1), (a)(2).

lines.[60] This section would collect these taxpayer rights common to all tax laws in a single place, either in the tax administration law or the basic law. At the commencement of any assessment or audit, the tax department should deliver a comprehensive description to taxpayers of their rights. However, these rights need not be unique to tax administration. Wherever possible, they should be accorded with other procedural rights guaranteed under law. A list might include some or all of the following rights.

1. *Confidentiality*

Taxpayers should have the right to have their personal financial information accorded the greatest possible confidentiality within the taxation authority.[61] This confidentiality should be breached only (1) during criminal investigations, when criminal investigators outside the taxation authority must view the information, (2) when so required during adjudication of a controversy, when an adjudicator must view the information, and (3) in certain other cases provided by law (e.g., disclosure of information pursuant to a treaty to the competent authority of a foreign government).

2. *Notice*

Taxpayers should have the right to be notified of an assessment, a decision on an adjudication, or any collection action against the taxpayer's assets.[62] The exception is the jeopardy assessment, when there is an imminent danger of the taxpayer disposing of the asset.[63]

3. *Reasonable Audits*

Taxpayers should have the right to have audits held at a reasonable time, in a reasonable place, and within reasonable limits.[64]

4. *Explanation*

Taxpayers should have the right to an explanation of why their tax is being assessed the way it is and to an explanation of the reasons for a decision by an adjudicator.[65]

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[60] Some countries even have official documents outlining the taxpayer's rights; examples of such documents include Canada's Declaration of Taxpayer Rights (1985), France's Charte du contribuable (1987), New Zealand's Statement of Principles (1986), and the United Kingdom's Taxpayer Charter (1986). OECD, *supra* note 34, at 70. *See also* ch. 2, sec. II(F).

[61] *See, e.g.*, DEU AO § 30; USA IRC § 6103.

[62] *See, e.g.*, DEU AO § 122; USA IRC §§ 6323, 6331(d), 6335.

[63] *See* USA IRC § 6331(d)(3).

[64] *See id.* § 7605.

[65] *See supra* note 42.

5. *Counsel*

Taxpayers should have the right during any dealings with the tax authority to be represented by a qualified professional.[66]

6. *Record*

Taxpayers should have the right to record their meetings with the tax authority and to have all adjudications recorded.[67]

7. *Discovery*

Taxpayers should have the right to advance access to the government's evidence in the case of an adjudication.[68]

8. *Hearing*

Taxpayers should have the right to a hearing before a decision is taken on an adjudication.[69]

9. *Appeal*

Taxpayers should have the right to an independent administrative appeal and a final judicial appeal.[70]

10. *Limitations*

There should be a limitation on the period during which an assessment may be made.[71] However, this limitation should be waived in the event of fraud on the part of the taxpayer.[72] The relevant rules should be specified in the tax administration law.

III. Taxpayer Compliance and Sanctions

Both substantive and procedural tax laws should always be directed toward improving taxpayer compliance. It is generally agreed that improving taxpayer compliance has many aspects to it, including making the law fair and

[66]In the United States, this right is guaranteed under the APA (USA).

[67]*See, e.g.*, USA IRC § 7521.

[68]*See supra* sec. II(F)(5).

[69]*See* USA IRC § 7458.

[70]*See supra* sec. II(F)(4).

[71]*See* GBR TMA § 34 (assessment of tax generally may not be made later than six years after the chargeable period); USA IRC § 6501(a) (assessment of tax made within three years after tax return was filed).

[72]In the United Kingdom, if tax was not paid on account of the taxpayer's fraudulent or negligent conduct, assessment may be made within 20 years of the chargeable period. GBR TMA § 36(1). If a U.S. taxpayer files a fraudulent return, files no return, or in any other way willfully attempts to evade tax, assessment may be made at any time. USA IRC § 6501(c)(1), (c)(2).

equitable, easy to comply with, and difficult to evade. Another important aspect of improving compliance is the provision of effective sanctions for failure to comply. Typically, sanctions can be of a civil or a criminal nature, and most jurisdictions provide for both, although in some jurisdictions criminal sanctions would be included in a separate criminal code.

However, there is much dispute as to what factors contribute most effectively to taxpayer compliance. Perhaps the most contentious area of controversy lies in the nature and function of both civil and criminal sanctions. Considerable variation exists with regard to the design of sanctions among different jurisdictions. However, social scientists have made considerable progress in understanding the various aspects of compliance and, most particularly, how sanctions work. Such information has made it possible to reach tentative conclusions as to preferred ways of designing them.

A. Existing Research into Compliance Issues

There is a large (and growing) amount of literature on taxpayer compliance, much of it focused on a single type of tax, for example, income, VAT, property, customs, and so on. This discussion will, where possible, consider some principles applicable to all of the above, but by and large most of the citations to research will be from studies on income tax compliance. Although the reasons for this focus are varied, the principal reason is that the majority of studies have been done in the United States, and the income tax is the most important and most studied tax there.

Much empirical research has been done on sanctions and income tax compliance in the developed world, and, as suggested, the body of literature on compliance in the United States in particular is quite substantial.[73] Unfortunately, while some theoretical and anecdotal work on compliance has been done in the developing world, there is little empirical work to guide policy planners. Therefore, if one is to use empirical research as a guide to designing rules for developing countries, it is necessary to rely excessively on studies from developed countries as a guide.[74]

In addition, unfortunately, much research into taxpayer compliance even in developed countries like the United States has been of rather dubious empirical value. Studies have tended to two different types: those undertaken us-

[73]Much of the pre-1990 taxpayer compliance research has been summarized and reviewed in two indispensable volumes: 1 Taxpayer Compliance (Jeffrey A. Roth et al. eds., 1989) and 2 Taxpayer Compliance (Jeffrey A. Roth & John T. Scholz eds., 1989).

[74]"Despite the huge economic literature on tax evasion, which fundamentally focuses on the appropriate role and implementation of penalties . . . there seems to be no empirical study of penalty design and effectiveness in developing countries. What studies do exist, mostly for the United States, appear to be both model- and country-specific . . . and cannot easily be generalized to the quite different circumstances of developing countries." Bird & Casanegra de Jantscher, *supra* note 2, at 5 n.8 (citations omitted).

ing official taxpayer data and those using self-administered questionnaires, although some studies have also used national accounts data. Unfortunately, taxpayer data are often incomplete and can rarely distinguish very well among types of compliance and noncompliance, while self-reporting is often inaccurate. In-depth interviewing and participant observation, while probably the most accurate way of learning about taxpayer behavior, is also the most difficult to undertake.[75] It may be that anecdotal evidence is the best that can be hoped for regarding many taxpayer compliance issues.

However, even though much of the social science work done may not be conclusive, the analysis can be helpful in thinking about the issues. Both theoretical and empirical studies in the general area of legal compliance, and the specific subcategory of taxpayer compliance, can give indications as to what the issues are and what might work, even if they cannot prove what might work beyond a reasonable doubt. Also, if one relies on social science research only as a general guide to understanding, it becomes easier to apply insights learned from such studies in developed countries to the different circumstances of developing countries.

Successfully developing rules that improve compliance requires at the outset two steps. First, a taxonomy of compliance needs to be developed, so that the relevant issues can be identified. Second, as the issues are identified, theories have to be formulated that can be tested against experience and that can then be used to create tax compliance principles. How the principles are implemented can be guided by specific examples, but the design of laws in a particular jurisdiction is likely to be sui generis, based upon the unique characteristics of that jurisdiction. For this reason, it is helpful to be able to return to the principles and their analysis as a guide for how to proceed.

B. Design of the Substantive Tax Law

Many taxonomies of tax compliance are reported in the scholarly literature. The most important breakdown is probably between unwilling and willing. First looking at the unwilling, people can fail to comply because (1) they do not know how, (2) it takes too much effort to do so, or (3) it is too expensive to do so.[76]

[75]*See* the discussion of this issue in Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance in* 2 Taxpayer Compliance, *supra* note 73, at 47, 64–66.

[76]Terms often used by writers on the topic include "unknowing noncompliance," "lazy evasion," or "lazy noncompliance." Taxpayer Compliance, *supra* note 73, at 20. Other different, but essentially redundant, terms are also used. *See* the reviews of the literature in Kidder & McEwen, *supra* note 75, at 50–62. Some rules may be particularly difficult to comply with. For example, in the United States, a special task force of the Internal Revenue Service singled out the complexity of the estimated tax rules that "frustrate[] taxpayers, particularly individuals, to the extent that penalties *are an acceptable alternative to compliance* (emphasis added)." Commissioner's Executive Task Force, Report on Civil Tax Penalties 15 (Feb. 27, 1989).

Related to this distinction is the ease with which a law may be avoided or evaded. A law that is easy to comply with may also be relatively difficult not to comply with. The most successful law will be one where these two properties coincide in a single law. In either case, it is the underlying substantive law of taxpayer obligations that must be designed so as to make compliance easy and noncompliance difficult.

The first and most obvious technique of filling both criteria is to reduce the total number of people who must make tax calculations, file returns, or pay money to the government. For administration of a VAT, this can mean restricting the collection of tax only to those who have a turnover of a certain size. For property taxes, it can mean using exemptions for properties of certain types or sizes.

For administration of an income tax, for example, it can mean exempting people below a certain income level from paying the tax and having as much tax as possible collected through a withholding system or pay-as-you-earn (PAYE) system. Withholding and PAYE form one of the central aspects of the administration of any income tax system. They can reduce significantly the actions that must be taken by taxpayers and reduce the number of persons who must ultimately file tax declarations.[77] In these instances, an intermediary, usually the person who employs the individual taxpayer or the person who makes periodic payments to the taxpayer, determines the tax and pays it.[78] That intermediary can also typically advise the taxpayer as to the applicable rules.

As a by-product of having intermediaries compute, withhold, and remit tax, the interaction between individual physical taxpayers and the administration and the associated paperwork are reduced. This is in effect a reduction in the cost of compliance for those taxpayers who have their obligations fulfilled, or intermediated, by others.[79] Success is reflected in less work for the individual taxpayer and a reduction in the total number of individual taxpayer declarations that need to be filed. Of course, in these instances, the interme-

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[77]Besides making it easier for a taxpayer to comply, withholding also makes it more difficult for a taxpayer not to comply. *See* vol. 2, chs. 14, 15. This was also the conclusion of the United States Internal Revenue Service Commissioner's Executive Task Force, Report on Civil Tax Penalties. Commissioner's Executive Task Force, *supra* note 76, at 37–42.

[78]For example, banks can be required not only to withhold and remit taxes on periodic payments, such as interest, but also to prepare and file declarations for income other than payments made by the bank itself. *See* Carlos A. Silvani & Alberto H.J. Radano, *Tax Administration Reform in Bolivia and Uruguay, in* Improving Tax Administration in Developing Countries, *supra* note 2, at 19, 29, 54–56; Charles E. McClure, Jr. & Santiago Pardo R., *Improving the Administration of the Colombian Income Tax, 1986–88, in id.* 124, 132. Of course, without a self-assessment system, some of the effort of preparing tax declarations and computing liability can be shifted to the administration. However, given the limited amount of administrative resources in developing countries, this hardly seems to be a wise idea.

[79]This also has the effect of shifting costs to those intermediaries. *See* Jaime Vázquez-Caro, *Comments, in* Improving Tax Administration in Developing Countries, *supra* note 2, at 145, 150.

diary also becomes a taxpayer; withholding or PAYE becomes a separate obligation enforceable by law.[80]

One of the frequently repeated dogmas of tax administration is that "legal simplification" also reduces the costs of taxpayer compliance.[81] A simple tax law may fulfill the twin requirements of being easy to obey and hard to disobey because it both allows the taxpayer, or taxpayer intermediary, to know more easily what is expected of him or her and also reduces manipulability of the law, thereby reducing the possibilities of tax avoidance.[82] Complexity, and the chance to avoid tax obligations, can come from a number of sources. Inconsistency within the coverage of the law certainly can be one. Exceptions or special rules that provide for reduced obligations in certain circumstances not only add complexity, but they also create an incentive for taxpayers to try and fit into those circumstances. The converse is also true: the more special circumstances where taxpayers have increased obligations, the more those circumstances will be avoided. However, when one considers policy justifications for particular taxes, legal simplification can turn out not to be a very simple task.

What constitutes simplicity and consistency in a tax law, at least with regard to tax avoidance opportunities, will depend on the policies behind the specific type of tax involved. The more that obligations can be designed to treat taxpayers and circumstances alike, the more consistent will be the law, and the fewer special circumstances will result. Second, in treating taxpayers and circumstances as alike as possible, the fewer and the more internally consistent the principles of such treatment, the better. With like treatment and limited and consistent principles, and language clearly reflecting those principles, interpretation of rules should be easier. The opportunity to avoid tax obligations would be reduced.

Unfortunately, these general principles can be very difficult to effect in practice. In fact, rules designed to make withholding and PAYE easier may frequently violate these principles, as do special provisions designed for administrative ease, such as exempt amounts and schedular withholding in the income tax. However, such complications and inconsistencies in tax rules should be approved only when there is a net administrative benefit.[83] While there may be no set of rules of thumb to decide when this will be the case, this should be

[80]*See* the discussion of the definition of the term "taxpayer," *supra* sec. II(B).

[81]*See, e.g.*, Henry J. Aaron & Harvey Galper, Assessing Tax Reform 42–44 (1985). Their call for legal simplification has been quoted often in tax compliance literature.

[82]Joel Slemrod discusses these issues in *Complexity, Compliance Costs, and Tax Evasion, in* 2 Taxpayer Compliance, *supra* note 73, at 156, 157–74. Of course, not all avoidance (or the organizing of one's affairs so as to reduce obligations without also evading) constitutes a compliance problem. Administration is concerned only with avoidance that results in a reduction in normative (or "correct") taxpayer obligations.

[83]*See generally* Richard K. Gordon, *Tax Administration Concerns in the Reform of Substantive Personal Income Tax Law in Emerging Economies*, 46 Bulletin for International Fiscal Documentation 163 (1992).

the explicit goal of the drafters of substantive tax laws. It would generally be wise for the drafters of substantive tax laws to consult with tax administration experts to ensure such a result.

C. Sanctions

1. *Purpose of Sanctions*

Sanctions are perhaps one of the most overrelied-upon, and poorly understood, tools for enhancing tax compliance.[84] Sanctions can also have more than one purpose. First, the most important component of sanctions is their ability to deter unwanted behavior, so as to bring about greater compliance.[85] Therefore, sanctions should be applied only to behavior that is reasonably capable of being deterred. Second, sanctions must be fair under the general jurisprudential criteria in effect in a particular jurisdiction. Under the jurisprudential principles of most jurisdictions, this means that sanctions should apply only when the sanctioned person is somehow at fault and should not be unduly harsh or disproportional, or imposed in violation of principles of due process. When the principles of deterrence and fault are combined, this leaves a general principle that faultless or reasonable behavior by taxpayers, even if it results in an underpayment of tax, should not be punished by sanctions. Only negligent or unreasonable behavior resulting in an underpayment should result in sanctions.[86]

In addition to their deterrence component, sanctions may also have an important financial component. Financial sanctions may raise revenue, while prison sentences may increase expenditures. Financial sanctions may even be designed in such a way that they cover the tax administration's expenses in pursuing a case, from investigation through final collection. Fines may also be designed to reduce administrative costs by encouraging the early settlement of disputes between administration and taxpayer.[87] This principle may appear to be

[84]Sanctions can be divided into types using a number of different criteria: civil and criminal, fines and imprisonment, per violation or per amount of tax forgone, or culpability of violation.

[85]There are two basic types of compliance failures: failures to provide accurate information when due and failures to remit the correct amount of money when due. The former (information) is important to the administration only in that it allows the latter (money) to be properly computed and remitted. Nevertheless, it can sometimes be easier to identify and assess a failure to provide information necessary for the proper remittance of tax simply by reference to the actual failure itself, rather than by attempting to put a money value on it.

[86]In the United States, for example, failure to file a return or to pay tax will result in sanctions unless such failure is due to reasonable cause and not willful neglect. *See* USA IRC § 6651(a)(1), (a)(2). In Belgium, if the taxpayer fails to file a return or files an incomplete or inexact return, he will be sanctioned. However, in the absence of bad faith, the taxpayer's sanction may be waived. BEL CIR art. 444.

[87]Tax codes encourage the taxpayer to pay his or her taxes by having the amount of the fine increase the longer the taxpayer withholds payment. *See* USA IRC § 6651(a)(1), (a)(2); GBR TMA § 93; BEL CIR art. 414; FRA CGI art. 1727.

self-evident. However, there are a number of jurisdictions, particularly among transition economies, where the principle is not followed under current law.[88]

In countries where government resources are extremely limited, these financial aspects of sanctions policy may be especially important, and the financial costs and benefits are of serious legitimate concern. However, in most instances, it will be difficult to fashion appropriate sanctions that fulfill both deterrence and other goals. Deterring behavior—which includes "encouraging" certain behaviors, such as the efficient settlement of disputes, or the remedying of violations, such as the failure to file or the failure to pay—should determine the design and severity of sanctions; the raising of revenues should be left to the taxes themselves.

Both financial and penal sanctions may also be designed to punish, not for the purpose of directly affecting the behavior of the person punished, but for the purpose of retribution or to indicate that society seriously disapproves of particular behaviors. As will be discussed below, the severity of sanctions may play a role in affecting people's attitudes toward the particular crime. For these two reasons, certain taxpayer activities that are viewed as particularly heinous, such as intentional evasion through fraud, are usually punished more harshly than less serious avoidance or error. Some jurisdictions punish such heinous behavior through both the civil system (e.g., increased fines for fraud) and the criminal system (additional fines and even prison terms for fraud).[89]

Although rarely discussed, another goal of sanctions policy should be not to cause (or worsen) other problems, that is, those outside the direct realm of tax administration. In at least two important instances, this goal will suggest that sanctions should be relatively limited in degree. This will be discussed at greater length below.

2. *Operation of Deterrence*

Leaving aside for the moment some of the subsidiary issues, the principal goal of sanctions is based on a simple premise—the threat of punishment deters unwanted behavior. If the likely punishment is sufficient to outweigh the prospect of gain, a rational person will not undertake the activity that will result in that likely punishment.[90] Even this most basic of statements of deter-

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[88]For example, the laws of both the Russian Federation and Kazakstan impose 100 percent penalties for understatement of tax, regardless of whether the taxpayer is at fault. RUS TS art. 13; KAZ TC art. 163.

[89]Penalties for such crimes as willful tax evasion or fraud may include monetary fines or imprisonment or both. *See* USA IRC §§ 7201–16. Willful tax evasion, for example, is considered a felony in the United States and is punishable by a fine of up to $100,000 or imprisonment of up to five years, or both, along with the costs of prosecution. *Id.* § 7201.

[90]Jeremy Bentham, the father of English utilitarianism, saw the choices between possible modes as based on a calculation of risks of pain and pleasure. This view is still a basic premise of most discussion of deterrence. *See* Johannes Andenaes, *Does Punishment Deter Crime?* 11 Crim. L. Q. 76, 79 (1968).

rence function depends on two important assumptions. The first is that it is possible to determine and create a likely punishment that appropriately outweighs the prospect of gain. The second is that people will act in a way that is measurably and understandably rational.

For a likely punishment to be accurately determined by an individual, he or she must first understand both what choices he or she has and what any possible adverse consequences of any choice will be. Only in such cases can the individual weigh the risks of detection and its consequences against the expected benefits of violation. Rational choice economists might state this as an equation: the taxpayer will commit evasion if the benefit the taxpayer receives is greater than the total punishment provided for violation multiplied by the likelihood of punishment.[91]

Rational choice theory does not simply mean that people are "rational" in the sense that they act in accordance with a single set of norms, for example, that they are profit maximizers.[92] People may act differently in response to a like set of circumstances and still act rationally; this is because they have different preferences or private utilities. Part of the individual's private utility function may be unrelated to specific statutory sanctions, such as informal sanctions of the community or individual preferences for obeying all laws or only certain laws.[93] However, looking first at the effect of official, state-sponsored sanctions, the private utility function of one individual is still likely to vary from that of another. In other words, to achieve a like effect, deterrents would have to vary from individual to individual precisely because individual utility functions differ.[94] For ex-

[91]The legal scholar and economist Steven Shavell describes the equation as one of the magnitude and probability of harm versus the magnitude of benefit. Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 Colum. L. Rev. 1232, 1236–38 (1985). A general discussion of rational choice theory in the context of taxpayer compliance can be found in Alfred Blumstein, *Models for Structuring Taxpayer Compliance*, *in* Income Tax Compliance: A Report of the ABA Section of Taxation, International Conference on Income Tax Compliance 159, 160–61 (Phillip Sawicki ed., 1983). This was also the conclusion of the United States Internal Revenue Service Commissioner's Executive Task Force, Report on Civil Tax Penalties, *supra* note 76, at 13–14.

[92]Most analyses of economic crimes do assume that criminals are principally profit maximizers. *See, e.g.*, the discussion in Michael Gerken & William R. Gove, *Deterrence: Some Theoretical Considerations*, 9 Law & Society Rev. 497, 497 (1975). With the exception of tax protesters, it is probably a good guess that tax evaders almost always do so to maximize monetary profit. Therefore, the differences in individual utility functions might be relatively less than among other criminals, and sanctions might be relatively easier to design. *See generally* Robert V. Stover & Don W. Brown, *Understanding Compliance and Noncompliance with Law: The Contributions of Utility Theory*, 56 Social Science Quarterly 363, 374–75 (1975). Unfortunately, as discussed below, even this simplification turns out to be unlikely.

[93]These two specific issues are addressed in greater detail at the text accompanying notes 120–24.

[94]To maximize social utility, the severity of sanctions against a particular behavior would have to increase as a particular individual's utility (in that behavior) increases. Samuel Kramer, *An Economic Analysis of Criminal Attempt: Marginal Deterrence and the Optimal Structure of Sanctions*, 81 J. Crim. L. & Criminology 398, 399 (1990).

ample, some taxpayers may have a greater preference for money now (say, through tax evasion) over later (say, when taxes and fines are finally due) than do other taxpayers.

The reasons for these different utility functions may be relatively more "objective" or "subjective." For example, some taxpayers may be poor or spendthrift and may be relatively indifferent to monetary sanctions because they are judgment-proof (i.e., immune from a money judgment because of insolvency, lack of property within the jurisdiction, or other reasons).[95] Others may simply prefer to live for the moment. That would mean that even if a sanction were certain to be applied and the cost (in present value terms) were greater than the amount initially saved, some taxpayers might still choose to evade, and yet could still be acting rationally.

Therefore, first, with regard to poor or judgment-proof taxpayers, there should be provisions in the law that allow debts to the government resulting from monetary sanctions to remain in effect even in the event of bankruptcy. Second, for both these taxpayers and those who are, for other reasons, indifferent to monetary sanctions, the most effective deterrent may be prison rather than fines. Therefore, while jurisprudential rules concerning the imposition of prison terms may restrict their application only to cases of criminal fraud, they may in certain circumstances act as a deterrent to these taxpayers. How these general policy conclusions might be implemented in a statute is discussed below.

However, other taxpayers might care very much about monetary sanctions, while still others, perhaps because of the lack of social stigma in their particular community, care little about prison sentences. It would be impracticable, and would presumably violate the principle of equality before the law, to provide completely individualized sanctions.[96] It would also probably violate the principle of equality if sanctions were designed to be infinitely strong so as to deter those least able to be deterred.[97] Therefore, for rational choice theory to be implemented in the design of sanctions, general rules must be created that are reasonable in the particular jurisprudential setting and that provide the greatest average deterrence. This would include the full panoply of monetary sanctions applied as effectively as possible, plus (in certain cases) nonmonetary sanctions such as prison terms.

Even allowing for some differences in individual utility functions, basic rational choice theory suggests that if sanctions are to work, they must be severe enough, and their chance of application likely enough, that the product

[95]Or, as Professor Shavell so succinctly puts it, "it is impossible to deter a person with no assets by the threat of monetary sanctions." Shavell, *supra* note 91, at 1237. This means that monetary sanctions can rarely be enough to act as a sufficient general deterrent to undesired behavior.

[96]*See supra* ch. 2, sec. II(A). This issue is also emphasized in the United States Internal Revenue Service Commissioner's Executive Task Force, Report on Civil Tax Penalties. *See supra* note 76, at 13.

[97]It would also probably be counterproductive. *See* the discussion concerning possibly counterproductive aspects of relatively high penalties, *infra* at text accompanying notes 114–17.

of these two exceeds the benefits of noncompliance for a sufficiently high proportion of the members of the target group. One direct corollary is that an increase in the perception of likelihood of being caught and punished results in an increase in the deterrence effect. This has been observed in the United States as a matter of general compliance with laws.[98] It has also been observed repeatedly in studies of tax compliance.[99]

The perception of likelihood of suffering sanctions depends on a number of factors, the first being the actual risk. That in turn will depend on (1) the ease of detecting noncompliance, (2) the ease of proving noncompliance, and (3) the administrative effort put into detection and proof.[100] Again, not surprisingly, tax studies in the United States have repeatedly shown that the easier it is to cheat and to hide the cheating, the more cheating will occur.[101] Any perceived risk is likely to differ from the actual risk and will depend on objective factors, such as how well the actual risk is publicized, and subjective factors, such as how well risk is processed and internalized by the taxpayer. Again not surprisingly, studies show that taxpayers who perceive higher probabilities of being subjected to legal sanctions are more likely to comply.[102]

Some research has suggested a number of less obvious refinements to the proposition that people are more likely to cheat if it is less likely that they will be caught. While rational choice theory may suggest that a reduction in probability of detection and punishment can be offset by an increase in severity of sanctions, there is considerable evidence that people are not very good at analyzing probabilities.[103] The first consequence of this fact is what criminologists refer to as the "tipping" effect.

Criminologists working in developed countries have found that within a given group of people there is a critical level of probability of punishment before which a marked deterrent effect is seen.[104] That point at which the

[98]A brief survey of some of the literature in the American context can be found in Scott H. Decker & Carol W. Kohfeld, *Certainty, Severity, and the Probability of Crime: A Logistic Analysis*, 19 Policy Studies Journal 2, 3–6 (1990).

[99]Some examples of research confirming this point include Robert Mason & Lyle D. Calvin, *A Study of Admitted Income Tax Evasion*, 13 Law & Society Rev. 73, 85, 87 (1978); Harold G. Grasmick & Donald E. Green, *Legal Punishment, Social Disapproval, and Internalization as Inhibitors of Illegal Behavior*, 71 J. Crim. L. & Criminology 325, 327 (1980).

[100]Many of these studies, each of which is concerned with income tax compliance in the United States, are summarized in 1 Taxpayer Compliance, *supra* note 73, at 97–110.

[101]*See id.* 27, 30, 88, 97, 107–10; Steven Klepper & Daniel Nagin, *The Anatomy of Tax Evasion*, 5 Journal of Law, Economics & Organization 1 (1989).

[102]*See* 1 Taxpayer Compliance, *supra* note 73, at 100.

[103]This is not terribly surprising when considering the popularity of lotteries. It is not just a question of whether some people are risk-averse while others are not, but a more general, systemic inability to judge risk accurately.

[104]This is discussed in Charles R. Tittle & Alan R. Rowe, *Certainty of Arrest and Crime Rates: A Further Test of the Deterrence Hypothesis*, 52 Social Forces 455, 456, 458 (1974). The article looked at general crime rates in the U.S. state of Florida.

likelihood of punishment "tips" into a compliance effect may not, in fact probably will not, fit with actual probabilities. As a general proposition, tipping seems to occur because people often tend to discount low probability events. It has been suggested, but not proved, that there may be a general tendency for people to think relatively more rationally about economic crimes than about other types of crime and, perhaps, that such rationality increases as the person's income increases.[105] Therefore, one might conclude that, at least with regard to other types of crime, tax evasion has a lower tipping point. Further, as a general matter the tipping point for a particular individual is perhaps likely to be lower (in other words, the individual is more likely to comply) if that individual's wealth or income is relatively greater. Because the wealthy, or those with higher incomes, are more likely to owe more in tax, one might also conclude that the tipping point is often inversely proportional (again, meaning that the individual would be more likely to comply) to increases in the amount of potential evasion. Nevertheless, this thesis does not suggest, at least in any absolute sense, where that tipping point would be.

The point at which a taxpayer would perceive that the probability of being caught is high enough that he or she would begin to comply may be influenced by different factors that would increase the taxpayer's awareness of punishment certainty.[106] This is because the tipping thesis depends on taxpayer awareness of the likelihood of punishment, and not just upon actual probability of punishment.[107] If taxpayers incorrectly believe that evasion is relatively common but is still not punished, the result could be tipping points higher than if the truth were better known. Another related point has to do with the percentage of people in the population who regularly comply or fail to comply. If a person violates a rule and is not caught, he or she may be more likely to commit another violation.[108] And, if many have this experience, they will be able to relate their success at evasion to larger sections of the population, resulting in a greater perception of the lack of consequences for failure to follow the law. The effects of perceived common evasion, plus one's own positive experiences of evasion, would both raise the tipping point and thereby reduce the effectiveness of sanctions.

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[105] *See generally* Philip J. Cook, *The Economics of Criminal Sanctions*, *in* Sanctions and Rewards in the Legal System: A Multidisciplinary Approach 50, 54 (Martin L. Friedland ed., 1989).

[106] For example, smaller groups with a high level of group communication may have an earlier tipping point and perhaps an increased tipping effect. Don W. Brown, *Arrest Rates and Crime Rates: When Does a Tipping Effect Occur?* 57 Social Forces 671, 680 (1978).

[107] There is a dearth of research into tipping and tipping points in tax compliance, even in the literature concerning income tax compliance in the United States. However, there is some. *See* the review in 1 Taxpayer Compliance, *supra* note 73, at 111.

[108] *See* the discussion in Raymond Paternoster et al., *Perceived Risk and Social Control: Do Sanctions Really Deter?* 17 Law & Society Rev. 457, 458 (1983).

There are a number of practical lessons to be learned from this analysis. First, in those areas of tax administration where there is sufficient successful detection of noncompliance and application of sanctions to exceed a tipping point, there could be considerable benefit in publicizing such detection and application of sanctions. Tax administrations can publish data on the number of taxpayers caught (or possibly even their names) and the sanctions applied. Active promulgation of such information should have a positive effect on future compliance.[109]

However, in areas where it is clear that a tipping point has not been reached, it would actually be counterproductive for a tax administration to advertise its relative ineffectiveness. In such instances, until detection of noncompliance and application of sanctions are sufficiently high, the tax administration should not publicize its efforts. For example, it may be possible that the application of sanctions to VAT noncompliers, or to those who do not comply with income tax withholding requirements, is much higher than to those who do not comply with income tax rules for self-employment income. In such a case, it might be wise not to publicize the tax administration's experience with self-employment compliance.

In making such determinations, however, the tax administration should recall that rates of detection of noncompliance and application of sanctions, and of tipping points, can vary among different populations. Therefore, for example, it may be that tax administration efforts may be more substantial, and more successful, among the wealthiest income tax payers. If so, publicity about successes in this subgroup could be beneficial in improving compliance among members of the subgroup.

Therefore, the tax administration should have the ability to collect the necessary information required to determine both rates of detection of noncompliance and subsequent implementation of sanctions as well as likely estimates for tipping points. It should also have both the authority and the means to publicize this information selectively.

It may seem obvious that increasing detection of noncompliance, and of applying sanctions to the noncompliant, would raise the likelihood that the tipping point would be exceeded. However, increasing the perceived likelihood of the imposition of sanctions may result in effects that, although rational, are counter to the standard deterrence effect hypothesized by rational choice theory. At his or her tipping point, the taxpayer assumes that the risk of detection is high enough that he or she will be subject to sanctions. At this point, the sanctions need be just severe enough for the taxpayer to comply.

[109]Depending on the jurisdiction, publication of the names of those taxpayers who are subjected to sanctions may raise issues of taxpayer confidentiality. For example, the U.S. Internal Revenue Service may only disclose to the general public a taxpayer's name and assessed penalties when a compromise is reached with the taxpayer before the case is referred to the Justice Department for prosecution. USA IRC § 6103(k)(1).

But if the taxpayer can take effective evasive action, he or she might be able to reduce the (self-perceived) probability of suffering from sanctions. Such action can include additional tax evasion or measures to hide the evasion. As the likelihood of being caught increases, either because of the nature of the substantive law (hard to avoid or evade) or of effective administration (more work in fighting avoidance and evasion), certain taxpayers may actually be driven into even greater acts of avoidance or evasion. Only if the taxpayer's evasive action is unlikely to be successful, or if the cost of the action to the taxpayer is likely to exceed the taxes saved, will the taxpayer comply.[110]

Putting more resources into effective tax administration may cost the exchequer money that could be better spent elsewhere.[111] However, it is also important to remember that more avoidance or evasion on the part of taxpayers carries a number of welfare costs. Both legal strategies for avoidance and illegal actions to evade are likely to have negative effects on resource allocation.[112] Therefore, even if net revenues (amounts collected minus costs in collection) were to increase with additional sanctions, there could be a net welfare loss to the economy in general, because of the changed nature of noncompliance.[113] Increasing the likelihood of being caught and subjected to sanctions works best if the taxpayer cannot easily take evasive action.

Although it is probably important for the perceived probability of being caught to be sufficiently high for there to be any deterrence effect from sanctions, there is not much evidence to suggest that compliance varies directly with the degree of severity of the sanctions. There has been an inconclusive debate among criminologists over why this is the case, although there is no clear evidence to suggest that the conclusion is wrong.[114] There are theories that people simply do not act rationally or that the theory of rationality must be correct and

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[110]If the taxpayer is uncertain as to the effectiveness of future evasive action, taxpayer costs will increase, in that uncertainty of success increases costs, while return remains the same. *See* James Alm et al., *Institutional Uncertainty and Taxpayer Compliance*, 82 American Econ. Rev. 1018, 1018–20 (1992). The author's understanding of these issues was greatly enhanced by a number of discussions with Professor Reinier Kraakman of the Harvard Law School.

[111]Despite the statements of some revenue authorities to the contrary, most have accepted that the goal of tax administrators is not to maximize net take, but to maximize total welfare. *See* Richard Goode, *Some Economic Aspects of Tax Administration*, 28 IMF Staff Papers 249 (1981).

[112]*See* Jonathan Skinner & Joel Slemrod, *An Economic Perspective on Tax Evasion*, 38 Nat'l Tax J. 345, 350 (1985).

[113]There are other possible effects. As taxpayers take greater evasive action, they may be inspired to commit even greater crimes. Also, if one method of avoidance or evasion becomes too difficult, they may abandon it but turn to others. *See* the discussion with regard to general deterrence theory in Jeffrey Grogger, *Certainty vs. Severity of Punishment*, 29 Economic Inquiry 279 (1991).

[114]*See* the survey of data in Decker & Kohfeld, *supra* note 98; *see also* the discussion in the context of tax compliance in Steven Klepper & Daniel Nagin, *The Criminal Deterrence Literature: Implications for Research on Taxpayer Compliance*, *in* 2 Taxpayer Compliance, *supra* note 73, at 126, 135–36, 143–44.

the data wrong.[115] Some criminologists have suggested that while the severity of formal sanctions in economic crimes like tax compliance may have little deterrence effect, informal sanctions may have greater effect.[116] However, increasing the severity of sanctions may also result in evasive action, under the same mechanism as that described previously regarding increased certainty.

The albeit insufficient empirical evidence might suggest that because an increase in severity does not change the point at which taxpayers become really afraid of being caught, it is unlikely to improve their compliance. However, such an increase in severity might nevertheless inspire them to take some extra precautions in their avoidance and evasion to ensure that they do not suffer those increased penalties. In fact, increasing the severity of sanctions without increasing their certainty to a tipping point would probably only have the detrimental effect of creating more avoidance and evasion, with the ensuing general loss to welfare.[117]

An additional cost of very high sanctions is that their imposition may well be unfair.[118] The sanctions, if disproportionate to the offense, would also be unfair. They would be unfair in their application if they reached only a small number of violators, since the violators who were caught would be much worse off than those who were not.[119] In tax administrations prone to corruption (including both the taking of bribes and the use of administrative powers against political opponents of the regime), the existence of unduly severe but not universally applied sanctions can constitute a dangerous weapon in the hands of corrupt officials. The general conclusion is that it is better to deal with noncompliance by imposing moderate sanctions more frequently than by having draconian sanctions that are rarely applied.

While fines and imprisonment may be the principal statutory responses to taxpayer noncompliance, they are not the only sanctions that figure in a

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[115]*See, e.g.*, Harold G. Grasmick & George J. Bryjak, *The Deterrent Effect of Perceived Severity of Punishment*, 59 Social Forces 471, 472, 475 (1980). They state that "the conclusion directly challenges the basic premise of deterrence theory that man is a rational actor." *Id.* at 472. They then go on to posit that this conclusion cannot *not* be correct, and that the data or analysis leading to the conclusion must be wrong. *Id.* at 473. Some might argue that this places theory above empiricism, an assertion that most scientists, at least since Newton, would fault.

[116]*See infra* text accompanying notes 120–21.

[117]There may also be a form of substitution effect where taxpayer compliance improves in those areas where a violation might draw the administrator's attention, but whose savings are less than those where certainty has not reached a tipping point. *See* the discussions of substitution effects in Michael J. Graetz et al., *The Tax Compliance Game: Toward an Interactive Theory of Law Enforcement*, 2 Journal of Law, Economics, and Organization 1 (1986); Klepper & Nagin, *supra* note 101, at 18–20.

[118]Also, it is often the case that the greater the severity of sanctions, the less likely that they will be fully applied. *See* Vito Tanzi & Parthasarathi Shome, *A Primer on Tax Evasion*, 40 IMF Staff Papers 807, 812 (1993).

[119]This point was also emphasized in U.S. Internal Revenue Service Commissioner's Executive Task Force, Report on Civil Tax Penalties, *supra* note 76, at 13.

taxpayer's rational choice calculus. Criminologists have recognized that the informal sanctions of social disapproval from peers have, in certain populations and for certain types of crime, also deterred criminal acts.[120] In many cases, the cultural climate regarding compliance may be even more important than the legal sanctions themselves. This may tend to be the case more with wealthier or more socially prominent subgroups, where social status is important and where social ostracism for criminal activity is more likely. Officers of prominent corporations, for example, may be particularly affected.[121]

While the literature on the subject is not completely convincing, the argument is powerful enough to suggest that it may be beneficial to make public the names of wealthy, powerful, or influential taxpayers who are punished for noncompliance. As discussed earlier, taxpayer confidentiality is an important right. However, once a taxpayer is actually sanctioned, any reason for protecting the name of the taxpayer is considerably weaker. Of course, if government in general or the tax system in particular is seen as corrupt or unfair, failure to pay may not be perceived as bad, and publicizing the names of those who did not pay would not result in social ostracism and greater deterrence.

Social ostracism is likely to increase with the relative heinousness of the crime. A study done for the U.S. Internal Revenue Service suggested that tax noncompliance, particularly tax evasion, might have less social stigma attached to it because the public often perceives it to be a "victimless crime."[122] This attitude may vary depending on who commits the crime. Experiences in places as diverse as New York State and India suggest popular support for government enforcement against the wealthy or powerful.[123] Presumably, the more the public understands tax evasion as a crime of moral turpitude, or one that injures the public at large, the greater the effect of social ostracism against tax evaders. Therefore, it may make sense for the tax administration to publicize adverse effects of tax noncompliance on other taxpayers, such as a general increase in tax liability for those taxpayers who do comply. Again, if government in general or the tax system in particular is clearly corrupt or unfair, no amount of publicity is likely to change the public's perception of these problems.

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[120] *See* Grasmick & Green, *supra* note 99, at 327–29.

[121] *See* Sally S. Simpson & Christopher S. Koper, *Deterring Corporate Crime*, 30 Criminology 347, 367 (1992).

[122] *See* Yankelovich, Skelley & White, Inc., *Taxpayer Attitudes Study: Final Report* (Public Opinion Survey Prepared for the Public Affairs Division, Internal Revenue Service, 1984). The study seems to suggest that perhaps large-scale evasion would not be seen as a victimless crime.

[123] The Leona Helmsley case in New York, where a wealthy hotel heiress was prosecuted for tax evasion, generated considerable support for the state tax administration. In India, arrests for tax evasion of major industrialists have also been popular. *See* Richard K. Gordon, Jr., *Income Tax Compliance and Sanctions in Developing Countries*, *in* Taxation in Developing Countries 455, 461 (Richard M. Bird & Oliver Oldman eds., 4th ed. 1990).

People also have propensities to obey laws for reasons other than the likelihood of punishment.[124] Not surprisingly, social scientists have suggested that people are likely to follow rules that they feel have a strong moral justification.[125] A large number of studies suggest that people who support the government in general and the tax laws in particular are more likely to comply with tax laws. If such morals are widely found within a group, then individual moral influences and the informal sanctions of the group are likely to coincide, reinforcing each other.

These individual and group views of morality can be affected by the existence of official sanctions. If a particular legal structure is viewed as legitimate by the target population, and as a general matter the severity of sanctions increases with the severity of crimes, then statutory sanctions may influence both personal and group views.[126] There may also be other ways for the government to influence people's propensity to obey the laws, from improving the perception of its own legitimacy to improving the perception of the legitimacy of particular laws. Wherever possible, these ways should be explored.

Another problem with increasing sanctions without increasing their certainty is that people may begin to view the system of tax administration as arbitrary and unfair. This problem can be magnified if sanctions are perceived to be enforced primarily against political enemies of the government in power. In addition, if sanctions are enforced largely against the less wealthy and powerful, or if the powerful and wealthy are known to escape sanctions, the public's perception of the justice inherent in the legal system can be substantially weakened. This could reduce compliance even further.[127]

3. *Design of Civil Sanctions*

A. Deterrence

As noted previously, in general, civil sanctions should be designed with two purposes in mind: (1) to deter certain unwanted behavior and encourage desirable behavior, and (2) to punish other, more heinous behavior. Looking first to the question of general deterrence, sanctions that are easily understood

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[124]Scholars may disagree as to whether the existence of personal morality is part and parcel of rational choice theory or describes another theory of human interaction. Some, for example, contrast rational choice models with "psychiatric models" of moral inhibitions or internalized norms. Andenaes, *supra* note 90, at 78–79. However, one can also include morality and internalized norms as aspects of individual utility functions. The important issue, however, is that people do not act solely to maximize dollar profit.

[125]That is, to avoid doing things that are wrong in themselves, as opposed to wrong because prohibited. *See* James J. Teevan Jr., *Subjective Perception of Deterrence (Continued)*, 13 Journal of Research in Crime & Delinquency 155, 157 (1976).

[126]*See* Gerken & Gove, *supra* note 92, at 502.

[127]*See* Gordon, *supra* note 123, at 462. *See also* Virendra Singh Rekhi, Notes on Legal Methods of Combating Corruption: Lessons from the Indian Experience (Nov. 15, 1995) (on file with the Legal Department, International Monetary Fund).

by taxpayers, and that are therefore easily applied and determined, are more certain in their outcome and more likely to affect a taxpayer's behavior, given that person's utility function.[128] Also, sanctions that are easily applied and determined are likely to take fewer administrative resources and are less likely to be subject to arbitrariness. Therefore, as a general principle, financial sanctions should be imposed as automatically as possible. Perhaps the most effective way to do this is to assess a general deterrence penalty, calculated as a percentage of the amount involved, for negligent or unreasonable failure either to (1) report the correct amount of income (or other tax base) on the return or to (2) pay tax when due.[129] Of course, a judgment will always be required to determine whether a failure is based on negligence. However, the degree of judgment required can be constrained. For example, there can be a presumption that a failure to pay an amount due is unreasonable and that the taxpayer has the burden of proving reasonableness.[130]

In addition to being easier to apply and determine, assessing penalties on the basis of the amount of underpayment makes sense within the logic of deterrence theory. As discussed previously, a penalty designed to deter should, within the constraints of tipping points and the irrationality of humans, raise the average cost of noncompliance so that it exceeds any average savings from noncompliance. Because the literature suggests little additional compliance as sanctions increase, there is likely to be little benefit to increasing formal sanctions beyond this point. In fact, greater sanctions may only increase avoidance and evasion activities, resulting in no greater overall tax compliance and perhaps in a net loss of social welfare to the economy at large. A monetary sanction should then be equal to an appropriate percentage of the benefit of noncompliance, although what percentage is "appropriate" is not always clear. In some instances it may be appropriate to apply flat-rate penalties. These instances are discussed below.

As discussed earlier, the tax administration should publicize rates of detection of noncompliance and implementation of sanctions whenever such rates are above a tipping point for that particular noncompliance. The tipping point should be measured within a particular identifiable subgroup of taxpayers. When appropriate, the deterrence effect of social ostracism may be exercised by publicizing the names of taxpayers who have been punished for noncompliance. Finally, the tax administration should undertake, where appropriate, public information campaigns to emphasize the injuries suffered by complying taxpayers when others fail to comply.

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[128]*See* Commissioner's Executive Task Force, *supra* note 76, at 13–15.

[129]*See* USA IRC § 6651(a); BEL CIR art. 444; DEU AO § 152. *See also* Commissioner's Executive Task Force, *supra* note 76, at 67–68.

[130]Upon failure to pay tax, the U.S. Code presumes that the failure to pay is unreasonable; a fine will be imposed unless the taxpayer can show that such failure was due to reasonable cause. USA IRC § 6651(a)(2).

B. Encouraging Resolution of Disputes

There are two ways to reduce or eliminate the incentive to drag out settlement of a tax dispute. The first is to require the taxpayer to pay all disputed amounts and penalties at the outset. The second is not to require payment at the outset, but instead to charge interest on both until they are paid. In the former case, the possibility that the taxpayer will later run out of resources to pay is reduced. However, if the administration is mistaken, such a rule can unfairly force the taxpayer to borrow substantial amounts, perhaps at high interest rates, and put the taxpayer in financial jeopardy, even if the administration must eventually pay interest to the taxpayer on overpayment. In extreme cases, the taxpayer may not only be unable to borrow the needed amounts, but may be unable to contest the assessment at all.

These problems are exacerbated by the fact that government and taxpayer are likely to have different credit ratings, meaning that risk premia are likely to be higher for the taxpayer as borrower than for the government as borrower. Even if the taxpayer receives interest on an overpaid amount, the interest may be much lower than what the taxpayer must pay on funds borrowed to make an initial payment of the amount in dispute. Another problem with regard to risk premia exists if the taxpayer is allowed to defer payment until the end of the dispute process. Unless interest is charged based upon the least creditworthy taxpayers, it will benefit those taxpayers to "borrow" from the government.

Different jurisdictions have reacted to this conundrum in different ways. Some require payment before any dispute settlement can begin, while others do not. Interest rates on overpayment and underpayment also differ among jurisdictions.[131] One possible compromise is to allow an impartial adjudicator to determine whether the taxpayer is required to pay. Taxpayers can then be encouraged to pay earlier by setting relatively high rates of interest on overpayments as well as on underpayments.

Another way to encourage the settlement of disputes is to reduce the penalty if early settlement is reached. For example, the penalty could be reduced by 50 percent if agreement is reached during the administrative stage and by 25 percent during the first litigation stage.[132]

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[131]In almost all of the OECD countries, the one exception being New Zealand, interest is imposed if the taxpayer does not pay his or her taxes on time. OECD, *supra* note 34, at 18–19, 62–66 (1990). Most of the OECD countries also compensate the taxpayer for overpayment with interest. *Id.* at 20, 83–84.

[132]The Colombian tax law is an example of such a system. In Colombia, "[i]f the taxpayer agrees to settle at the time of the initial field audit by the tax authorities, the penalty is 20 percent . . . of the underpayment. If a formal demand for supplementary payment made by the tax administration is accepted by the taxpayer before the case goes to court, the penalty is 40 percent. If the taxpayer agrees to the increased assessment after the case goes to court, but before the final judicial determination of liability, the sanction is 80 percent." McLure & Pardo, *supra* note 78, at 136. Thus, Colombian tax laws encourage settlement of disputes.

C. Punishment

To punish particularly heinous behavior, an additional civil penalty can be charged for underpayment attributed to willful evasion, fraud, or reckless indifference.[133] This penalty can be determined as a percentage of the portion of the underpayment that is due to such willful evasion, fraud, or reckless indifference.

D. Flat-Rate Penalties

Although sanctions should in general be fixed as a percentage of the deficiency, in some instances it may be desirable to fashion penalties in an even easier, more predictable, and more automatic way than assessing a percentage against the amount of underpayment of tax. This will be the case when there is at best an indirect connection between an action and an underpayment of tax. For example, flat amounts can be charged for each instance of failure or error and can include a flat penalty for failure to file a required document (tax return, information return) or for filing certain documents incorrectly (information returns).[134]

4. *Severity of Civil Sanctions*

Perhaps the most important lesson to be found in the research literature on sanctions is that they are ineffective unless taxpayers believe that there is sufficient likelihood that they will be caught and that the sanctions will actually be applied. As noted earlier, the most important activity that a tax administration can undertake to ensure the voluntary payment of taxes is to ensure that noncompliance is readily discovered, that the discovery results in the application of sanctions, and that the public is made aware of the difficulty of escaping noncompliance detection. These measures will lower the tipping point, resulting in greater compliance behavior by more taxpayers. In short, the most effective sanction is not the sanction per se, but the rate of enforcement. As a general matter, therefore, those tax laws that are relatively easy for the tax administration to check or audit (meaning also that they are hard to avoid or evade) will have the greatest potential for compliance. Such laws are also likely to be the easiest for the taxpayer to comply with.[135]

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[133]*See* USA IRC §§ 7201–202 (willful tax evasion and failure to collect or pay tax are felonies); DEU AO § 370(3)1 (penalty for tax evasion is increased if committed out of gross self-interest and is of a large scale).

[134]*See, e.g.*, USA IRC § 7203 (penalty imposed for willful failure to file a tax return); FRA CGI art. 1725 (penalty imposed for failing to file required documents). Similar points were raised in the United States Internal Revenue Service Commissioner's Executive Task Force, Report on Civil Tax Penalties. *See supra* note 76, at 15, 42–43.

[135]*See also* Rekhi, *supra* note 127.

For tax laws that are harder for the tax administration to audit, it will be more difficult to ensure a low tipping point. However, unless the tipping point is low enough, increasing sanctions is unlikely to result in a decrease in evasion. The risk that greater sanctions may result in a net loss of social welfare is more substantial when the law is more difficult to enforce and when additional avoidance and evasion behavior is more likely to be successful. In addition, if the tax administration appears to be punishing relatively few noncompliers with very harsh sanctions, the law will be perceived as arbitrary, as well as a vehicle for politically motivated prosecutions. Therefore, regardless of whether the particular tax law is easy or difficult to administer, sanctions need not be substantial. Sanctions that are already established at significant levels should not be increased in severity as compliance decreases, although this approach may seem counterintuitive.

It is difficult to determine both the actual tipping points for particular populations and the chances of being caught and forced to pay. It is even less likely that these determinations can be made for different types of avoidance or for different population subgroups. It can be said, however, that the exact percentage of the amount of underpayment that should be charged would vary from jurisdiction to jurisdiction, although the variation should not be too substantial. Also, the difficulty of determining these factors when combined with the benefits of uniformity suggests that penalties should be uniform for all taxes. The most important point, however, is that efforts should focus on making compliance with the laws easier, making avoidance easier to detect, improving tax administration enforcement efforts, and, when those efforts are successful, publicizing those efforts.

The size of the penalties would vary from jurisdiction to jurisdiction depending upon the factors discussed above. However, in most cases, penalties should probably not exceed 25 percent of the amount of underpayment for negligence or 50 percent for intentional underpayment.[136]

In the case of additional civil penalties for the more heinous activities of evasion, the additional goal of punishment comes into play. The level of such sanctions should first be based on the legal traditions of punishment viewed as desirable in the particular jurisdiction. However, this starting point should be adjusted to take into account the adverse affects previously discussed of having particularly high sanctions. However, it is unlikely that a civil penalty for fraud should exceed 100 percent of the amount of underpayment.[137]

[136]For example, the U.S. Internal Revenue Service Commissioner's Executive Task Force, Report on Civil Tax Penalties concluded that the civil penalty for underpayment owing to negligence (i.e., no reasonable care) should be 20 percent, with a *de minimis* rule, while the penalty for intentionally underpaying (although without fraud) should be 50 percent. *Supra* note 76, at 67–68.

[137]For example, the U.S. Internal Revenue Service Commissioner's Executive Task Force, Report on Civil Tax Penalties concluded that the civil penalty for underpayment due to fraud should be 100 percent. *Id.* at 68.

5. *Rules to Increase the Effectiveness of Civil Sanctions*

Because of the economic nature of tax noncompliance, monetary sanctions are not always effective deterrents. One example is where the noncomplier is judgment-proof, meaning the taxpayer has no resources to pay any amount due, including underpaid tax, interest, and any monetary sanction. First, legal rules should provide that the government has appropriate priority over other creditors. In particular, bankruptcy laws should be drafted so that tax liabilities are not extinguished in the bankruptcy of a physical person and that tax liabilities are given priority in the reorganization or winding up of a legal person.[138] Second, there must be legal rules that allow the taxation authority automatically to secure liens against the taxpayer's unsecured assets, to garnish wages, and to levy property. Also needed are rules against the conveyancing of assets to others in order to avoid government claims.

Although the rules of priority, bankruptcy, lien, attachment, execution, and fraudulent conveyancing are designed to protect the government's claim, there may still be instances where the taxpayer is relatively judgment-proof. Some have suggested that in these instances nonfinancial penalties, such as prison terms, should be added. However, most legal systems would not tolerate the imposition of prison terms for civil offenses.[139] Civil sanctions could, however, include the temporary suspension of certain privileges, such as to practice as a chartered accountant. Some jurisdictions revoke business or other licenses from delinquent taxpayers.[140] Revoking such privileges, while acting as a deterrent, may actually reduce the ability of the taxpayer to pay off his or her government debt and may have the undesired effect of damaging the economy, and increasing unemployment, by essentially prohibiting a business from operating.

It may make sense to allow such nonmonetary sanctions to be applied only after a taxpayer fails in good faith to make payments under a payment plan. The taxation authority can increase the effectiveness of informal sanctions by publicizing tax violations. Such informal sanctions would apply to all delinquent taxpayers, but may have particular importance for those debtors who are judgment-proof. Sanctions are also ineffective when someone other than the noncomplier will step in and pay the fine, for example, when legal persons, such as companies, are taxpayers. The physical persons who undertake the execution of the tax law liabilities of legal persons may not be subject to an adequate financial sanction if only the legal person, and therefore the legal person's owners, suffers. Therefore, financial sanctions must be addressed

[138]*See, e.g.*, Bankruptcy Code, 11 U.S.C. §§ 507(a)(7), 523(a)(1) (USA).

[139]No OECD country provides for prison terms for civil tax offenses. *See* OECD, *supra* note 34, at 19. While in most countries imprisonment is one possible sanction for tax crimes, it is very rarely imposed.

[140]For example, in the United States and the United Kingdom, tax deficiencies may result in a loss of privileges, including the ability of attorneys and accountants to practice their trade. *Id.* at 19, 67–69.

not only to the legal person, but also to the physical person. If the physical person is indemnified against any sanctions by the legal person or by others, the sanction will also not work.

These problems can be at least partially addressed by including a "responsible physical person" penalty. Such a penalty would make those physical persons who are responsible for collecting and paying taxes for legal persons liable for failure. Jurisdictions that have such responsible person penalties usually restrict them to certain types of noncompliance. In the United States, for example, such a penalty exists only for the failure to withhold the appropriate amount of taxes on payments to third parties and on failure to pay the withholding over to the government. The "penalty" for such failure is equal to the amount of underwithholding or underpayment; the responsible persons are jointly and severally liable, along with the legal person.[141] However, responsible persons are not penalized for failure to pay income tax amounts due. This is probably due to the fact that, as discussed previously, withholding rules are very simple to implement and failure to withhold can be attributed clearly to a limited number of people.

The same cannot be said for the determination of income tax liability. Other taxes, such as VAT and excises, may also be easy enough to implement, so that a failure to collect and remit these taxes could also subject the responsible person to penalty. A 100 percent responsible person penalty suggests that the purpose of the penalty is not simply to extend deterrence to the physical person in charge, but perhaps also to help collect the amount of underpaid tax when the legal person is judgment-proof. In the United States, the responsible person penalty makes any person required to pay tax over to the IRS liable for the tax.[142] Because the taxes chosen for such a penalty are easy to determine and collect, and easy for the tax administration to check or audit, the tipping point for the deterrence effect can be made fairly low, which means that sanctions would be more likely to be effective and high sanctions would be less likely to have additional negative welfare effects through increased avoidance and evasion behavior. The nature of these taxes also suggests that high penalties are not necessary. Therefore, the total amount of tax collected from all responsible persons through this penalty should not exceed 100 percent of the tax due, plus interest and other applicable penalties.[143]

6. *Criminal Offenses by Taxpayers*

Fraud or evasion is usually considered a crime,[144] but it is often a difficult crime to prove. Some countries have therefore set forth other acts that may be

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[141]USA IRC §§ 3402, 3403, 3505, 3509, 6672; *see also* AUS ITAA §§222AOA–222AOD.

[142]USA IRC § 6672.

[143]This is the case in the United States; while the IRS may assess 100 percent penalties against all responsible persons, it may enforce such assessments only until it has collected an amount equal to the tax liability. Gens v. United States, 615 F.2d 1335 (Ct. Cl. 1980).

[144]*See, e.g.*, USA IRC §§ 7201, 7202.

part of a scheme of fraud, but that, in themselves, constitute crimes and that may be easier to prove than a fraudulent scheme. The punishment for these crimes is usually less than the punishment for fraud. If the taxpayer is convicted of fraud, these other crimes should not apply. These crimes include submitting false documents and interference with tax administration through libel, slander, or other means designed to influence official action either positively or negatively.[145]

Criminal offenses would be in addition to civil penalties. They can be subject to flat fines and even to terms in jail. However, as with all penalties, high criminal penalties may only result in taxpayers' taking greater care to disguise their fraud.[146] Depending on the country's legal tradition, the provisions imposing a criminal penalty could be included in the tax administration law or in the criminal code. Wherever located, the general rules of criminal procedure should apply.

7. *Tax Administrator Penalties*

Unless the matter is governed adequately in the other laws, special civil and criminal penalties can be applied for tax administrators. They can include civil penalties for negligent failure to follow accepted procedures or to respect taxpayer rights. Depending on the jurisdiction, these penalties could be imposed as damages based on taxpayer suits as part of (or an addition to) the general law of civil liabilities. Permitting taxpayer suits in these cases could act as a substantial deterrent to corrupt behavior on the part of officials. Criminal behavior of tax administrators may already be penalized under the criminal code.[147] Some laws also provide for criminal penalties for private income tax preparers who disclose confidential taxpayer information.[148]

[145]For example, in the United States, the Internal Revenue Code includes the following acts as crimes punishable by fines and prison: making fraudulent statements in a tax return or information return, making fraudulent statements under penalty of perjury, and removing or concealing information with intent to defraud. USA IRC §§ 7204–207.

[146]*See* discussion *supra* sec. III(C)(2).

[147]For example, in the United States, the Internal Revenue Code includes the following acts as crimes punishable by fines and prison: numerous acts by revenue officers or agents, including extortion, bribery, conspiracy to defraud, and failure to report the illegal acts of others. USA IRC § 7214. The Internal Revenue Code supplies a cross-reference to a penalty provided in the U.S. criminal law relating to officers of the United States who trade in public funds, debts, or property. *Id.* § 7214(c).

[148]*See, e.g., id.* § 7216.

5

Regulation of Tax Professionals

Victor Thuronyi and Frans Vanistendael

Bad ethics drive out good.

—*Adapted from Gresham's Law*

It would be difficult to have a well-functioning tax system without tax advisors. Because most taxpayers are not familiar with the intricacies of the tax laws, tax advisors are needed so that taxpayers can fulfill their complicated tax obligations. As informed members of the public, tax advisors also provide input to the formulation of legislation and regulations.

By counseling taxpayers on how to comply with their legal obligations, tax advisors serve an important public interest; the state has an interest in fostering and protecting this role. The role of tax advisors, however, differs from that of the tax authorities in that their primary loyalty is to their client, not to the state. An important function of the regulation of tax advisors is to help strike an appropriate balance between loyalty to the system and loyalty to the client.

Regulation also has the goal of protecting clients from unscrupulous or incompetent tax advisors. Here, the regulatory interest of the state is similar to that in other areas of consumer protection. The danger is that such regulation might serve instead to protect the economic interests of those permitted to act as tax advisors, or might strangle the free exercise of the profession by creating undue bureaucratic control.

This chapter reviews the regulation of tax advisors in different countries. Such a review is multifaceted, for several reasons. First, different countries have adopted rather different regulatory approaches. Second, tax advice is typically given by different types of professionals—lawyers, accountants, auditors

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and others—each of which may be subject to independent regulation of its profession. Third, "tax advice" covers a multitude of different activities, which can be performed by professionals with different qualifications and which may call for different regulatory approaches. Fourth, tax advisors do not operate purely domestically, and a different regulatory approach may be appropriate, for example, for foreign tax advisors who render advice within a country, perhaps to a largely foreign-based clientele. Finally, the role of tax advisors cannot properly be viewed in isolation from a country's culture and its legal and economic system. Therefore, approaches that may work in one country may not be appropriate for another.

Because of the practical importance of tax advisors for the functioning of the tax system, it is important that the system of tax legislation provide an underpinning for their role, whatever regulatory approach is adopted in a particular country. At a minimum, the law should spell out the taxpayer's right to use a representative and the consequences of that use. Whether it is appropriate to go beyond this and provide more detailed regulation is a matter to be decided in light of the circumstances of the country concerned and the stage of development of the tax advisory profession in that country. In most transition countries, there are very few tax advisors. This is due to the youth of the tax system as a whole and to the fact that there has not been time for professional education and experience. In part because of the paucity of tax advisors, taxes in these countries are often designed so as to minimize the number of taxpayers who must take positive action with respect to their tax affairs, for example, through the use of final withholding taxes and registration thresholds. Detailed regulation of tax advisors would not seem to be a top priority for transition countries, compared with other areas where the tax system needs development. Nevertheless, several transition countries (e.g., China, Poland, and the Slovak Republic) have undertaken such regulation.

I. Basic Policy Considerations in Regulating Tax Advisors

A. Balance of Supply and Demand

Regulating a profession by imposing conditions for admission inevitably reduces the supply of potential professionals. Whenever a service industry is regulated, a rough balance between supply and demand for professional services should be maintained. Therefore, in any proposal to regulate a professional service, like tax advice, it is of crucial importance to know in advance how many people can be admitted to the profession immediately or within a short period of time, given the regulations contemplated. The standards of experience and education that are set in the regulation will to a large extent determine the volume of the supply of tax advisors. Flexible transitional measures may also have a major impact on the balance between supply and demand for tax services.

On the demand side, an analysis should be made of what type of professionals will be required by what type of taxpayer. For example, there is a huge difference in qualification requirements between a tax lawyer able to take complicated cases in court and a person able to prepare simple returns for small rural businesses. The demand for tax advisors will depend, among other things, on the development of the economy and the legal system and on requirements imposed on taxpayers (e.g., how many taxpayers are required to file returns). On the supply side, the major constraint in many countries is likely to be the availability of proper training.

The necessity of providing a rough balance between supply and demand for tax advice is of decisive importance in deciding (1) whether or not to regulate the profession, and (2) how to regulate the profession and more specifically what the qualifications should be for admission to the profession and whether the profession should be granted a monopoly on some or all aspects of tax practice.

The most burning political question concerns granting a monopoly for the exercise of the profession. From the point of view of the tax profession, a monopoly may be highly desirable. However, it is the general interest and not the interest of the profession that should decide this issue. The general interest is best served by high-quality service at a low price. A monopoly is supposed to exclude incompetence and low quality but tends to result in higher prices and may in certain circumstances result in corruption (e.g., there can be corruption in terms of entry to the profession). Moreover, a monopoly cannot fully exclude incompetent advice. If incompetent advisors can make it into the monopoly, and are able to keep competent advisors out, then a monopoly offers a lower quality of advice than a regime of free competition. Quality standards can also be fostered by regulatory measures that do not create a monopoly.

A monopoly for tax advice is also difficult to enforce. A great deal of tax advice is generated by the activities of professions such as accountants (internal audit), auditors (external audit), lawyers (advising on business transactions, tax litigation), notaries (conveyancing), real estate agents, and customs agents. Each of these activities can in its own right involve some form of tax advice. Establishing a monopoly for tax advisors will not exclude all these professionals from offering tax advice. This means that establishment of a monopoly is not likely to be very effective in achieving the desired policy goals.

Moreover, an alternative means is available for providing consumers access to a regulated profession. The profession can be regulated and its title protected by law (which means that an individual who is not duly accredited is not allowed to use the title of tax advisor), but without giving members of the profession a monopoly on tax advice. Under such a scheme, consumers would have the choice of obtaining tax advice from an accredited tax advisor or of consulting another professional. This solution maintains competition between rival professions in the market for tax advice, while at the same time setting adequate quality standards for the profession of tax advisors. It is one possibil-

ity among the alternative approaches to regulation discussed in section III of this chapter.

B. Maintenance of Quality Standards

Maintenance of quality standards does not necessarily involve a legally imposed regulatory scheme. For example, in the Netherlands there are two strong private organizations that impose strict rules on their members.[1] Although there is no official recognition of these private organizations, the Ministry of Finance considers them to be representative partners in dealing with problems of the tax profession. These organizations police the quality of their members and accordingly offer the public a choice about whom to consult on tax matters. Their private status gives them flexibility in setting professional standards. However, such a situation, whereby a private organization imposes quality standards on its members, requires time and tradition to develop. This model would probably be difficult to follow in most countries in transition.

Many developing and transition countries that decide to regulate tax practitioners may choose to determine professional requirements by law rather than by relying on private organizations, unless these are well developed. The question of the professional qualifications required for admission is a difficult one, because the profession is in practice exercised at very different quality levels, ranging from quite simple to highly sophisticated. In setting educational and professional standards, one should also take into account a country's educational and professional tradition.

In the United Kingdom, for instance, professional education of lawyers and accountants traditionally took the form of on-the-job training, while the role of universities and other institutions of formal education was rather limited. This may be related to the English tradition of professional education in which solicitors and barristers traditionally learned their trade at the Inns of Chancery and the Inns of Court in London rather than in universities. In more recent years, however, the norm in the United Kingdom has become a university degree. In setting standards for admission, a country having a similar tradition of on-the-job training could put more emphasis on professional experience than on university degrees. Countries with a strong tradition of academic education in law or other relevant disciplines (e.g., accounting) can rely more on degrees in setting standards for admission.

Keeping in mind the basic requirement of a balance between supply and demand for tax advice, limitations on resources for training and education are likely to constitute the major bottleneck in the supply of tax advisors in developing and transition countries. To avoid such bottlenecks, any regulation

[1]These are de Nederlandse Orde van Belastingadviseurs (NOB) [The Dutch Order of Tax Advisors] and de Nederlandse Federatie van Belastingconsulenten (NFB) [The Dutch Federation of Tax Consultants].

should avoid exclusive channels of access to the profession. When the main requirement is professional experience, the law regulating the profession should not give the profession exclusive control over quality standards, but should share this control with the government, enabling the latter to keep channels of access open. When the main requirement is a diploma or degree, the law should provide that the government can organize official examinations for candidates without the degree, requiring the same level of competence as the examinations organized by universities and other institutions of higher learning.

A model of the latter approach can be found in the Eighth European Directive of April 10, 1984,[2] regulating admission to the auditing profession. This directive requires candidates to have a university-level education and practical training.[3] This theoretical education can be provided either by universities or other institutions of higher learning or by the profession itself. The same holds for practical training. The important thing is that the directive provides for alternative channels of access (universities or the profession). The directive is also flexible in that it does not require the applicant to take courses and lectures. The only requirement is that the applicant present a theoretical examination on a minimum number of courses and proof of practical training.[4] The applicant has the choice between a university or other school of higher learning, or an examination board organized by the state. This is not to suggest that degree requirements for tax advisors should all be set at the university level: a multilayered approach may be more advisable.[5]

Finally, in implementing a regulatory scheme that involves professional standards, it may be necessary to provide for a transitional period during which access to the profession is permitted on the basis of an examination, in a few areas that are essential to tax practice, such as general principles of tax law, substantive law of major taxes—such as income tax (individual and corporate) and value-added tax or turnover taxes—tax procedure and company law, and accountancy, without any formal requirement of prior education (except basic secondary education). The exact program could be detailed by regulation. Examinations could be organized by universities or other institutions of higher learning, or by educational centers of the tax administration that organize the training of tax officials.

C. Conflicting Loyalties of Tax Advisors

The development of appropriate regulation of tax advisors must recognize the dichotomy between the state's interest in raising revenue and in applying

[2]Council Directive 84/253, 1984 O.J. (L 126) 20.

[3]*Id.* art. 4.

[4]*Id.* arts. 4, 5, 8.

[5]*See infra* sec. II.

its taxation law in a consistent, efficient, and equitable manner and the client's interest in minimizing tax.

Some taxpayers are prepared to violate the law in order to pay less tax. Others wish to act legally but to obtain as much after-tax profit as possible. They will legally seek to do this by exploiting inconsistencies and ambiguities in the tax legislation. Where different tax consequences follow two different forms of a transaction, the taxpayer will, if properly advised, often adopt the form that incurs the lowest tax burden. Similarly, if two types of transaction bear different tax burdens, the taxpayer can be expected to characterize the transaction employed by the taxpayer as one qualifying for the lower tax burden. And, finally, where there is some ambiguity in the application of the statute, the taxpayer will seek to interpret the ambiguous wording in the most advantageous way possible.

In addition, a taxpayer may consult an advisor to make sure that a particular transaction or business structure does not result in unfavorable tax treatment or to learn how to comply with tax legislation.

An underlying question is the extent to which, in different circumstances, the tax consultant must act in the interests of the state or the client if the interests of the two parties diverge. This question should be borne in mind in considering the various functions that a tax advisor can perform. The basic rule in most countries is that the private tax advisor must act in complete independence from the tax administration. The tax advisor must of course respect all legal obligations that flow from the tax law, but his or her primary loyalty lies with the client, the taxpayer. For example, the advisor must generally respect client confidences and may not report the client to the tax authorities.[6] This independence results from the general attitude taken toward professional services, such as those of lawyers, physicians, and accountants. This independence may be very valuable, particularly in transition countries, which until recently had an experience of interference by public authorities in all areas of public and private life. The loyalty to the client is not, however, unqualified. A tax advisor is not generally permitted, for example, to participate in fraud or to lie to the government.[7]

Some countries have a different emphasis. According to the Japanese Law on Certified Tax Accountants of 1951, the mission of a certified tax accountant (CTA) is to implement the taxpayer's obligation to pay taxes as stipulated in the law. The CTA must be impartial between the taxpayer and the tax administration and make the CTA's position clear to both parties. The Japanese Ministry of Finance may also disbar or suspend a CTA; some argue that this makes the professional subject to the tax administration to some degree.[8] Similarly, in

[6]*See infra* sec. I(H).

[7]*See* Bernard Wolfman et al., Standards of Tax Practice § 403.2 (3rd ed. 1995).

[8]*See* Masayoshi Hanaki, Japanese Certified Tax Accountant System (paper presented at International Seminar, Beijing, Apr. 1994).

countries with rules contemplating the certification of a tax return by a professional, the professional on his or her personal responsibility certifies that the return is in compliance with the law, thereby placing the tax advisor in a position of some independence vis-à-vis the client.[9]

Closely tied to the question of loyalty is the question of whether tax officials may practice as tax advisors. This question is particularly crucial in transition countries because the tax administration may constitute the only reservoir of professional expertise for private practice. Regardless of the circumstances, the basic rule should be that an official of the tax administration is prohibited from engaging in any form of private tax practice while in government employment.[10] The reason for this incompatibility between public and private tax practice is that it is impossible to serve two masters at the same time. There would be a clear conflict of interest between loyalty to the tax administration on the one hand and loyalty to the client on the other.

This incompatibility should not be confused with the duty of the tax official to help some kinds of taxpayers file their tax returns. In many countries the tax administration opens its offices to taxpayers who are illiterate, low-income, or elderly. The taxpayer must be aware that the tax official is acting in the exercise of the official's public office in providing this service. These services can be provided for small taxpayers with simple tax returns reporting fixed salaries or pensions. They should not be open to taxpayers with important sources of revenue, because in such instances they could easily result in corruption.

Another question is whether a tax official can enter into private tax practice after leaving the tax administration. Tax officials often resign from their official duties to accept lucrative consulting jobs in the private sector. Basically, this should be permitted in developing and transition countries. However, to avoid a massive flight from the tax administration into private practice, after the tax officials have completed their professional training in the tax administration, a minimum number of years in public service could be imposed.[11] Finally, and in order to avoid a conflict of interest, a former tax official should be prohibited from dealing as a private advisor with files with which the official has been in contact directly or indirectly while working for the tax administration.[12]

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[9]*See infra* sec. IV(A).

[10]*See, e.g.*, 31 C.F.R. § 0.735-20, -21(b), -39 (1994) (USA) (Treas. Dept. employees may not engage in outside employment involving a conflict of interest; federal employees may not act as attorney or agent of a party in a case before a court or agency where the government is an opposing party).

[11]This could take the form of a promise that is not legally binding, a contract with a damages clause, or a legally imposed period prohibiting private practice for a certain time if the minimum length of service is not satisfied.

[12]*See* 18 U.S.C. § 207 (USA); Treas. Dept. Circ. No. 230, § 10.26 (USA) [hereinafter Circular 230]. In Germany, there is also a three-year waiting period before a former tax official may represent a client whose tax matters the official dealt with. *See* DEU StBerG § 61.

D. Relationship Between Tax Consulting and the Legal and Accounting Professions

The variety of functions performed by tax consultants overlaps the responsibilities ordinarily carried out by other professionals, chiefly lawyers and accountants. Thus, it is impossible to consider the regulation of tax consultants without considering how the legal and accounting professions are regulated, the extent to which these professions are guaranteed monopolies in practicing in their respective areas, and the extent to which tax consulting activities are considered the practice of law or the practice of accounting.

In almost all jurisdictions, controls are placed on who is entitled to practice law or accountancy. The controls usually work in conjunction with measures that provide for the establishment and recognition of independent, self-governing professional bodies that are responsible, among other things, for establishing the prerequisites for admission to practice in the profession, the continuing education and other conditions for continuing qualification, and the disciplining of members of the profession with respect to breaches of their professional responsibilities. Legislation imposing criminal sanctions is often used to enforce the professional monopolies and restrict practice to persons who meet the requirements of the state and of the relevant professional body.

The boundaries between legal advice, accounting advice, and advice that is neither legal nor accounting are inherently unclear in the tax area. All advice about tax *law* can be characterized as legal advice. Jurisdictions vary in the extent to which they give a monopoly on the provision of legal advice to lawyers and on how they define the monopoly. In countries such as the United States and France, which restrict the provision of legal advice to lawyers, there can be disputes about the extent to which the provision of tax advice by nonlawyers is the unauthorized practice of law. In Germany (and other countries with analogous regulatory schemes), the situation is more complicated, because there is a legally created monopoly on both the practice of law and on the practice of tax advice, so that the lawyers' monopoly must make exceptions to take into account the competing monopoly of the tax advisors, and vice versa. No jurisdiction, however, has provided that only lawyers may give tax advice, because so many other professionals deal with tax matters.[13]

Because legal, accounting, and tax services are so closely connected, it is desirable to approximate certain professional rules in the three professions. If those professional rules were very different, competition between the three professions could be distorted. The areas in which professional rules should be approximated include the following: (1) permissibility of advertising, (2) rules for professional liability, (3) the parallel activities that are compatible with the exercise of the profession, (4) whether a person can become a member of more than one profession and which profession would then control professional and

[13]*See infra* sec. II.

ethical standards, (5) whether a legal person can become a member of the profession, (6) fees, (7) privileged information, and (8) ethics, for instance, conflicts of interest, limitations on holding financial interests in clients, and procedures for a client to consult another professional.

The difficulty of segregating legal and accounting advice from tax advice and from business and financial planning advice does not arise with respect to other functions performed by tax consultants where the nature of the service is easy to identify, namely, the preparation of tax returns and the representation of a taxpayer in contacts with revenue authorities or before an appeals board or court. The relative clarity of these latter functions probably explains to a large degree why, as explained further below, in some jurisdictions[14] efforts to supervise and regulate tax consultants concentrate on these responsibilities.

E. Admission of Legal Persons to the Profession

The development of rules allowing or disallowing tax advisors to operate through different business forms will depend in part on the conceptual model underlying the profession to which the advisor belongs. Two competing models have emerged—the traditional concept of a liberal profession as it has been developed in continental Europe and the more modern Anglo-American concept of a profession providing intellectual services through entities such as the big accounting or law firms. In the former concept, the person of the practitioner takes a central position and the practitioner's personal qualities determine the quality of his or her professional practice. In the latter, the organization and its techniques and procedures are crucial, and the person of the practitioner is of secondary importance because the practitioner's quality is determined by the working procedures of the organization. These two alternatives are not mutually exclusive because systems permitting practice by legal persons also allow practice by individuals.

If legal persons are admitted to practice as such, two basic issues arise, one with respect to the professional quality and responsibility of the individuals working for the organization and another with respect to the independence of the organization from its clients and the rules with respect to conflicts of interest and other matters of professional ethics.

Preservation of the virtues of personal professional responsibility and quality of the services provided are good reasons for not admitting legal persons to the exercise of the profession. The argument that admission of legal persons is necessary for the buildup of large organizations is not valid. The existence of major European and American law firms that have several hundreds of lawyers and thousands of employees, and that are not admitted to practice as an organization, is sufficient to refute this argument.

[14] *See infra* secs. II(D–F), III.

However, some countries (such as France and Germany) have chosen to admit legal persons to practice.[15] Under such a system, a major policy question is the extent to which a director, partner, shareholder, or employee is required to be an individual member of the profession with all rights, privileges, and responsibilities related to that status. In the extreme case, one could have a firm with only one individual being a member of the profession and all other partners and employees not being members. It is clear that certain minimum standards should be fixed as to the level in the organization at which individuals must be members of the profession.

Closely tied to this question is that of corporate control. If a firm is admitted to the profession, it is important to know who will control it. If bankers, industrialists, and shopkeepers can exercise control of a tax consulting firm, it will be very difficult to enforce the standards of ethics and independence of the profession because no banker, industrialist, or shopkeeper is bound by such standards. Again, if one takes the independence and ethics of the profession seriously, it would seem that the minimum rule ought to be that control over all professional decisions must be in the hands of persons who, as individuals, are members of the profession and subject to its ethical rules. This may require a majority of the outstanding capital and of the votes in the general meeting of shareholders and even exclusive representation on the board and other bodies of the legal person.[16]

The admittance of legal persons to the profession also raises some secondary questions, namely, how ethical rules can be enforced against a legal person and how the legal person can participate in the life of the profession (voting rights in the general meeting of the professional association, representation on its executive board, etc.).

F. Regulation of International Tax Consulting Services

Those countries that leave the tax profession largely unregulated do not face a problem in dealing with foreign practitioners. Where a country seeks to establish a monopoly on tax practice, however, problems arise in applying the regulations to tax consulting services that cross borders.

Consideration of the tax implications of international transactions and investments will inevitably involve consideration of local tax laws and the tax laws of the jurisdiction in which the other party to the transaction or investment is resident. In the case of multinational corporations, it is likely that the

[15]*See* DEU StBerG §§ 3(1)1, 49, 72, 74; Loi No. 90-1258 of Dec. 31, 1990, relative à l'exercice sous forme de sociétés des professions libérales soumises à un statut législatif ou réglementaire ou dont le titre est protégé, J.O. Jan. 5, 1991 (FRA) [hereinafter Loi No. 90-1258]. The Slovak Republic has changed its rules to prevent limited liability companies from providing tax consultancy services. *See* Alzbeta Bobáková, *LLCs Can No Longer Provide Tax Services in Slovakia*, 11 Tax Notes Int'l 32 (1995). The law regulating tax advisors is SVK TAL.

[16]*See* DEU StBerG §§ 50, 50a; Loi No. 90-1258, *supra* note 15, arts. 5–13.

tax implications in many jurisdictions, where various branches of the company are resident, will have to be taken into account before the details of a transaction can be finalized.

Persons qualified to provide advice on domestic taxation are unlikely to have sufficient knowledge of relevant foreign tax systems to advise on all aspects of the foreign law. To obtain that information, a taxpayer will quite likely require the advice of a foreign tax consultant. The qualifications required of (and supervision of) foreign tax consultants will depend on how the advice is provided. The advice can be sought directly by a taxpayer in the country or through a tax consultant practicing in the country. In both cases, the advice can be sought in a number of ways, such as asking an expert abroad to provide advice; arranging for a foreign advisor to visit the country for a brief period; using a foreign expert who is resident in the country; or having the tax analysis be done in another country where a multinational is based or has operations.

Pragmatic considerations suggest that it is difficult to regulate the provision of this sort of advice. Excessive regulation might result in simply pushing businesses to seek tax advice offshore. It should also be taken into consideration that foreign tax advisors are likely to bring international technical expert knowledge to the tax profession that a country may very much need to participate in international economic transactions. A pragmatic solution strongly suggests *not* to establish a monopoly for tax advice, or at least not to establish a monopoly on international and foreign tax practice, so as to leave foreign tax experts free to practice in the international area and in the domestic tax area of their country of origin.

Moreover, jurisdictions that are part of a common market area may face legal constraints in imposing restrictions on freedom of establishment and the freedom to provide cross-border services that discriminate against foreign nationals.[17] A foreign professional who has been qualified abroad may wish to practice in the country without having fulfilled all the in-country educational requirements normally required of domestic individuals who wish to become licensed. If certain aspects of tax practice are restricted to persons with given qualifications, this problem can be dealt with by providing for a simplified procedure for foreign practitioners to qualify to practice in the country in recognition of the fact that they have already had to become qualified abroad.[18]

When foreign members of a regulated profession are allowed to practice in a country, an important question arises as to which will be the competent disciplinary authority: the authority of the territory in which the activity has been exercised or that of the territory in which the professional was admitted to practice. This question has not yet received a final answer. It is clear that international law firms and accounting firms would prefer disciplinary author-

[17]*See supra* ch. 2, sec. II(G).

[18]*See, e.g.*, DEU StBerG § 36(3) (simplified procedure for citizens of other EU states).

ity to rest with the competent authority of the country in which the professional has been admitted to practice. They are familiar with those rules, and application of those rules would provide legal security, which may be necessary to convince an international tax advisor to practice in a country that is otherwise unknown to him or her.

On the other hand, a country may want to subject foreign members of a regulated profession allowed to practice in the country to the same professional rules as its own national professionals. Different professional rules may distort competition to the disadvantage of domestic professionals.

G. Provision of Tax Services by Employees

Any regulatory scheme should take account of the fact that the major portion of tax services to corporations is provided not by outside advisors but by employees. The regulatory interest in controlling what employees can do is weak, since presumably the employer can exercise the control desired. Generally, employees are free to provide tax services to their employer without any state control over their qualifications, except in cases involving representation of the employer before a court,[19] and they may be exempted from requirements that apply to independent tax advisors.[20] In drafting a regulatory scheme, the supply and demand implications of service rendering by employees should be taken into account. Moreover, it should be clearly specified which activities can be undertaken without government control. A regulatory scheme that is restrictive and leads to a scarcity of available advisors will create pressure for corporations to do their tax work internally rather than to retain outside advisors.

H. Privileged Communications and Work Product

In many countries, professionals rendering tax advice enjoy professional privilege under which documents furnished to, and communications with, a tax advisor may be exempt from disclosure to the government.[21] Usually, the rules in this area follow the general rules of privilege. Communications to lawyers may be eligible for privilege, but communications to accountants or tax advisors who are not lawyers are generally not. Not all communications to lawyers are privileged; thus, privilege generally extends only to communications in confidence for the purpose of obtaining legal advice. Financial documents,

[19] *See, e.g.*, Circular 230, *supra* note 12, § 10.7(c).

[20] *E.g.*, Finance Act 1995 § 172(1) (IRL)(employee not subject to rule described *infra* note 30).

[21] This is known in some countries as professional secret (in France, *secret professionnel, see* Décret No. 91-117 of Nov. 27, 1991, organisant la profession d'avocat, J.O. Nov. 28, 1991, and in Germany, *Berufsgeheimnis, see* DEU AO § 102(1)3(b)). For discussion of professional privilege in the tax area in the United States, *see* Wolfman et al., *supra* note 7, at § 306.4.4.1; Michael Saltzman, IRS Practice and Procedure ¶ 13.11 (2d ed. 1991).

however, furnished to a lawyer for the purpose of tax return preparation might not be privileged because they have not been prepared by the client for the purpose of confidential communication to the attorney.[22] Communications made to an attorney for the purpose of return preparation might not be privileged because the preparation of tax returns does not constitute rendering legal advice.[23] On the other hand, the taxpayer's attorney's work product (e.g., notes analyzing the taxpayer's case) may be immune from disclosure to the tax authorities.[24] The U.S Supreme Court has not, however, extended the attorney work product doctrine to accountants.[25]

Where privilege is available with respect to some professions, but not with respect to tax advisors generally, there is a distortion of competition between tax advisors who are members of different professions, since taxpayers may prefer an advisor to whom communications are protected by privilege. On this basis, some of the distinctions that are drawn between different professions in the recognition of privilege can be faulted.[26]

Many tax administrations are opposed to professional privilege for communications to tax consultants, because it would impede the efficiency of tax audits. Obtaining information about the client's tax affairs from an advisor can be a particularly useful tool for the tax administration, because the tax advisor may have analyzed the client's situation and identified points of weakness in positions the client has taken.[27]

The question of privilege comes up where the government seeks to obtain documents or testimony from the tax advisor. A related, but distinct, issue is the advisor's responsibility to keep client confidences; that is, are there any circumstances under which the advisor is permitted or required to report the client's misconduct to the tax authorities? The general obligation to maintain client confidences is imposed by the general professional standards that govern the practice of lawyers and accountants. A duty to maintain confidentiality

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[22]*See* Colton v. United States, 306 F.2d 633 (2d Cir. 1962).

[23]*See In re* Schroeder, 842 F.2d 1223 (11th Cir. 1987).

[24]*See* Hickman v. Taylor, 329 U.S. 495 (1947); Upjohn Co. v. United States, 449 U.S. 383 (1981).

[25]*See* United States v. Arthur Young & Co., 465 U.S. 805 (1984).

[26]*See, e.g.*, Nancy Loube, *Attorney-Client Privilege in the Context of Section 6662*, 10 Tax Notes Int'l 2103 (1995).

[27]For example, in United States v. Arthur Young & Co., 465 U.S. 807 (1984), the IRS sought the tax accrual workpapers of the taxpayer's accountant through an administrative summons. Tax accrual workpapers are the independent auditor's papers used in the process of determining the adequacy of the corporation's reserve account for contingent tax liabilities. "Tax accrual workpapers also contain an overall evaluation of the sufficiency of the corporation's reserve for contingent tax liabilities, including an item-by-item analysis of the corporation's potential exposure to additional liability. In short, tax accrual workpapers pinpoint the 'soft spots' on a corporation's tax return by highlighting those areas in which the corporate taxpayer has taken a position that may, at some later date, require the payment of additional taxes." *Id.* at 813.

may also apply to tax advisors who are not lawyers or accountants if these are regulated.[28]

As a general matter, the practitioner may not reveal client confidences to the government. For example, if a client commits tax fraud, a practitioner representing the client in an audit who learns of the fraud from the client may not inform the tax authorities. Instead, the practitioner may be required by professional standards of practice to advise the client to inform the tax authorities of the fraud. If the client refuses to do so, then the practitioner may be required to cease representing the client, if continuing to do so would make the practitioner a party to the fraud.[29] Ireland has recently amended its tax law to require an advisor to a company who becomes aware of certain tax offenses committed by the company to first ask the company to report the situation to the tax authorities.[30] If the company refuses to do so, then the advisor is required to cease working for the company as auditor or as tax advisor for a period of three years.[31] If the advisor who is required to resign is an auditor, the advisor must notify the company of his or her resignation and send a copy of the notice of resignation to the tax authorities.[32] An exception is provided for a person assisting or advising the company in preparation for legal proceedings.[33]

II. Tailoring Regulation to Functions of Tax Advisors

The resolution of the interests of the state and of the taxpayer requires a multifaceted response in light of the fact that the category "tax consultants" encompasses persons with quite different roles and responsibilities. For example, in situations such as those of a lawyer defending a client against criminal prosecution, it is appropriate for the advisor to act with total loyalty to the client, subject only to the ethical principles that apply to lawyers (such as the duty not to lie to a tribunal). In other cases, such as where the tax advisor assists in planning transactions, it is not appropriate for the advisor to act as aggressively as possible in the client's interest.[34] A preliminary step in regulating tax consultants, therefore, is to identify the different types of consultants and consulting activities and to consider each separately in the context of alternative regulation models. This section reviews the different functions that are typically performed by tax advisors, and how considerations for regulation might differ for each.

[28]*See* Wolfman et al., *supra* note 7, § 403.1.1; USA IRC § 7216.

[29]*See* Wolfman et al., *supra* note 7, § 403.2.2.

[30]Finance Act 1995 § 172(2) (IRL).

[31]*Id.* § 172(2)(b).

[32]*Id.* § 172(3).

[33]*See id.* § 172(2)(b); *See also* Miriam H. O'Brien, *Ireland: Parliament Passes Finance Act 1995 With Controversial Reporting Obligation for Tax Advisors*, 10 Tax Notes Int'l 1955 (1995).

[34]*See* Wolfman et al., *supra* note 7, §§ 501–505.

A. Tax Planning

Tax advice, because it can be approached from different angles, is part of a much wider package of legal and economic services, including auditing, accounting, financial, legal, and management services. Tax problems can arise not only from the company's accounts and records, but also from legal obligations flowing from company law, securities regulation, bankruptcy law, and so on. Therefore, it is important to recognize that many different kinds of professionals will deal with tax problems as a natural extension of their nontax activities. In countries with complex tax laws, virtually every business or financial transaction may call for review of its tax implications. Advice on tax planning can therefore arise in quite different contexts and be given by different professionals, not just by tax specialists.

B. Advice Ancillary to Financial and Other Services

Tax advice is also provided by some ordinary business enterprises like banks, insurance companies, brokerages, and real estate companies as a service ancillary to their main business. For example, life insurance products may be eligible for special tax treatment, which insurance brokers will explain to clients. The same will be true for many financial products. The advice given here will typically be very narrow in scope, focusing on the tax treatment of the financial product being sold. These business enterprises cannot be compared to independent professions and should not be regulated like independent professions, provided that their tax services remain truly ancillary to other economic activities. In Western Europe, the financial services industry has recently been seeking to enter the market for tax services, thereby raising the question of whether those activities should be regulated the same way as the independent professions.

C. Preparation and Auditing of Commercial Accounts

A primary function of commercial accounts is to provide financial information to the owners and creditors of a business. Commercial considerations have led to the imposition of standards and controls on persons preparing or auditing commercial accounts. In most cases, the qualifications for preparing accounts are less severe than those for the independent professionals who audit accounts (certified public accountants). While the commercial accounts may be of great importance in the determination of tax liability,[35] there is usually no regulation by the tax authorities of persons preparing commercial accounts.

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[35]*See* vol. 2, ch. 16.

D. Preparation of Tax Returns

Countries with a system of licensed tax professionals will typically stipulate that only persons who are licensed as return preparers may prepare a return for remuneration. Even when a country does not want to regulate the tax profession or tax advice as such, it may wish to have certain controls on the persons who prepare and file tax returns on a taxpayer's behalf. The minimal rule may be that when the taxpayer does not personally prepare the tax return, the person who prepares the return has to identify himself or herself. This allows the taxpayer to hire anyone to prepare the return, but it also permits the tax administration to keep track of professionals engaged in the business of preparing returns and to impose penalties where called for.

In any scheme that imposes requirements or restrictions on return preparers, it will be necessary to identify who is a preparer. In most cases it is easy to identify the preparer. However, in the case of complex returns, many people may contribute to the preparation of a return. In these cases, a person furnishing substantial information or advice that is an input to the preparation of the return may appropriately be considered a return preparer. Of course, under this rule, it is possible that many persons will be considered preparers with respect to a single return. For some purposes, one can provide special rules limiting the number of preparers (e.g., one could provide that only the principal preparer must sign the return).

E. Representation of Taxpayer Before the Tax Administration

A tax advisor representing a taxpayer before the tax authorities acts as an advocate. Because of the skills required, there are often restrictions as to who can act in this capacity, and the rules typically differ depending on the procedural formality that the proceedings take. When the profession is regulated, it is generally provided that the tax advisor may represent the taxpayer before the tax authorities. Generally, this right of representation is shared with other professions, such as lawyers and accountants. Representation can take place to obtain a ruling; in connection with audits or investigations, before or after assessment; and before administrative tribunals or tax boards.

F. Representation Before the Courts

In some countries, all tax litigation is decided by the civil courts, rather than by administrative courts. In countries where administrative tribunals initially hear a case, depending on the rules of tax procedure, appeals in tax litigation are most often decided by the civil courts, while tax fraud and tax evasion belong to the competence of the criminal courts.

Representation of taxpayers before the civil or the criminal courts is generally reserved exclusively to lawyers. The argument in favor of restricting ap-

pearances in courts (or administrative tribunals with procedural rules similar to those of courts) to lawyers is that professionals who may be tax experts but are not litigation experts may not be qualified to serve their client in such a setting. However, in countries where there is a comprehensive regulation of the tax profession, tax advisors may also be permitted to represent taxpayers in litigation before the civil courts. In such cases, specific competence in legal or tax procedure is most often required. Representation of taxpayers in criminal cases is the exclusive competence of lawyers in most countries.

Where nonlawyers are allowed to represent taxpayers, they are often required to be licensed by the tribunal and must take an examination for this purpose.[36] Particularly if the number of lawyers available to take tax cases is inadequate, this kind of licensing might be a solution to providing professional representation for taxpayers.

III. Approaches to Regulation

The extent of regulation of the tax profession differs substantially from country to country. Three general approaches can be identified. The first, exemplified by Austria, China, Germany, and Japan,[37] establishes a regulated professional monopoly for tax practice (similar to the professional monopoly that lawyers enjoy in many countries for legal practice) that is shared in most cases with other regulated professions such as lawyers and accountants. The second, exemplified by the United States, does not establish a monopoly for tax advice or return preparation, but does restrict certain representational activity to licensed practitioners and members of other regulated professions and involves a well-developed regulatory framework. The third, which most countries follow, involves an essentially unregulated tax profession that coexists with regulated professions such as lawyers and accountants. However, the regulations applicable to these professions do not deal specifically with the provision of tax services. Within these three general approaches, there are differences in detail in different countries' approach to the tax profession.

A. Full Regulation: The German Model

In Germany, the Tax Consultancy Law[38] comprehensively regulates the provision of tax advice. Article 2 provides that assistance in tax matters on a commercial basis may be provided only by persons who are authorized to do so by the law. Under article 3, those who are generally competent to give tax ad-

[36] *See, e.g.*, U.S. Tax Court Rule 200(a), 60 T.C. 1152 (1973).

[37] *See* Law on Certified Tax Accountants of 1951 (JPN); State Administration of Taxation, Interim Measures on Tax Agents (Sep. 16, 1994) (CHN); DEU StBerG.

[38] DEU StBerG.

vice are licensed tax advisors, lawyers, accountants, and auditors. Thus, a person who is licensed as a lawyer or an accountant need not obtain a special license for tax practice, but no other person may generally give tax advice without a license. The seriousness of this general restriction of tax practice is underscored by article 4, which lists in detail the limited situations in which nonlicensed persons may provide tax advice.[39] To become a licensed tax advisor, an individual must follow a program of courses and take an examination. A separate regulation provides a schedule of allowable fees.[40]

B. Partial Regulation: The U.S. Model

Like Germany, the United States regulates tax practice.[41] The scope of this regulation is, however, much less extensive than in Germany in that anyone, even someone with no professional training or qualifications, is allowed to give tax advice[42] or to prepare a return for someone else. A person preparing a return is, however, required to sign it as preparer. This requirement allows penalties to be imposed, if warranted. It also makes the return preparer take responsibility for the return, which is important in and of itself. Finally, by keeping track of persons signing as return preparers, the tax authorities can detect whether returns with particular problems are originating from particular preparers. In the United States, as part of signing the return, the preparer must list the name of the firm, his or her social security number (which is used as the tax identification number), and the employer identification number (i.e., the tax identification number) of the firm. The use of identification numbers enables the tax authorities to keep track of return preparers with greater certainty.

Other types of representation before the Internal Revenue Service are restricted to persons who are attorneys, certified public accountants, or enrolled agents.[43] Enrolled agents are regulated by the Treasury Department; they are generally required to take an examination and may be disbarred for miscon-

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[39]For example, to list only 3 of the 13 cases listed in article 4, patent lawyers are allowed to give tax advice within the scope of their work as patent lawyers, employers are allowed to render assistance to their employees in matters concerning taxation of wages, and administrators of property may give advice with respect to the property they administer. *Id.* § 4(2), (10), (8).

[40]*See Steuerberatergebührenverordnung reprinted in* Deutsche Steuergesetze 1992, at 1192 (4th ed. 1992).

[41]*See, e.g.*, Circular 230, *supra* note 12.

[42]However, if the rendering of tax advice is considered to be legal advice, then it may constitute the unauthorized practice of law (and therefore be prohibited) if done by someone who is not an active member of the bar. Because the practice of law is regulated by each state, this is a matter that is not regulated by the federal tax authorities.

[43]*See* Circular 230, *supra* note 12, § 10.3. Enrolled agents must generally either pass an examination or be a former IRS employee with sufficient experience. *Id.* § 10.4. To remain in good standing, enrolled agents must satisfy continuing professional education requirements. *Id.* § 10.6. A similar regulatory scheme applies in Israel. *See* ISR IT §§ 236–236H.

duct. A person who is not otherwise eligible to practice before the IRS but who has prepared a return that is being audited may represent the taxpayer in the audit proceedings (but not before the Appeals Office).[44] Before the Tax Court, a taxpayer may be represented by an attorney or by someone who has been admitted to practice before the court by taking an examination.[45] Nonattorneys cannot represent taxpayers in other courts that hear tax cases.

Another country with partial regulation of tax practitioners is Australia, where only lawyers and tax agents are allowed to prepare returns for remuneration; thus, accountants must be registered as tax agents in order to carry out such work.[46] Taxpayers may deduct fees for tax advice only if the advice is furnished by a registered tax agent or by a barrister or a solicitor.[47] A recent policy review in Australia conducted jointly by revenue authorities and professional bodies recommended that qualified accountants who are not tax agents be allowed to charge a tax-deductible fee as well.[48] Overall, the Australian regulatory scheme as it currently stands falls somewhere between the U.S. and the German models in that there is effectively a monopoly provided both on the provision of tax advice and on return preparation, although the regulatory scheme is not as comprehensive as the German.

C. The Model of No Regulation

In many countries, including Belgium, Italy, Portugal, Spain, and the United Kingdom, the provision of tax advice and return preparation is generally unrestricted as to profession. Some countries, however, provide special treatment for certain professionals in certain circumstances.[49]

With the exception of countries following the U.S. or German models, representation before the tax authorities is relatively unrestricted. Most countries allow representation by nonlawyers in administrative proceedings, since these are not based on formal procedure and rules of evidence that might apply in court. Often, the return preparer defends the case.

D. Issues in Regulation of Tax Consultancy

The issues to be dealt with in any regulation of the tax profession depend, of course, on the type of regulation that is to be introduced: full regulation, partial regulation, or no regulation at all. However, even in the third case there

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[44]*See* Circular 230, *supra* note 12, § 10.7(c)(1)(viii).

[45]*See* USA IRC § 7452; U.S. Tax Court Rule No. 200, 60 T.C. 1152 (1973).

[46]*See* AUS ITAA § 251L(1).

[47]*See id.* § 69(4), (11) (there is also an exception for persons who are exempt from registering as an agent, but this is of limited application).

[48]*See* National Review of Tax Standards for the Tax Profession, Tax Services for the Public 73 (1994).

[49]*See infra* sec. IV.

may be a need for some rules, to govern cases where the taxpayer is assisted in filing the tax return, or is represented by someone else before the tax administration.

In the model of full regulation the following items should be taken care of:

(1) The question of whether tax consultants should have a monopoly, and the sanctions for violating the monopoly.[50]

(2) When the regulation does not provide a monopoly, it should determine the nature of the advantage of title protection, which titles (e.g., tax advisor, tax consultant, tax lawyer, or tax accountant) are protected, the sanctions for violating this protection of title, and the obligation always to use the title in professional tax practice.

(3) Apart from the advantages of monopoly or title protection, the law should also list any other advantages to be provided, such as facilities in representing taxpayers before the tax administration, in communicating documents and notifications to the tax administration, or obtaining delays for filing or payment, and waiver of penalties.

(4) Regardless of whether there is a monopoly, or only title protection, the regulation should set out which activities are protected under the law: advice, preparation of tax returns, representation before the tax administration, litigation in courts, and services ancillary to these activities.

(5) Regardless of the scope and the nature of the regulation of the profession (monopoly or title protection), exceptions should be made for other professions that are closely connected with tax advice, such as lawyers, accountants, auditors, notaries, real estate agents, and patent advisors for the tax aspects of their field of activities.[51]

(6) The regulation should also specify the educational standards required for admission to the profession.[52] Two things should be regulated: the level of education (university, vocational) and its content (accounting, basic principles of public and private law, major taxes, and the rules of professional ethics). Depending on the level of educational requirements, practical experience may also be required.[53]

(7) Any full regulation of the profession should also contain organizational rules on the creation of an order or an institute, with a seat, a board, a general meeting, membership dues, a list of licensed members, and bylaws.

[50] *See supra* sec. I(A).

[51] *See* DEU StBerG §§ 3, 4.

[52] *See supra* sec. I(B).

[53] For example, in the German model, the duration of practical experience increases as the level of education decreases. *See* DEU StBerG § 36.

(8) The supervision of the profession should also be regulated. The choice is between supervision by the tax administration, by a self-governing body (as for the legal and medical professions), or by a body with representatives of the general public (consumer protection agencies) and the tax administration. The way in which the profession is supervised also determines the nature of disciplinary measures and procedures, which should also be spelled out in the professional regulation, as well as rules on the relationship between disciplinary law and ordinary civil law (professional liability) and criminal law.

(9) The regulation should stipulate whether legal persons can be admitted as full members of the profession.[54] It should also indicate whether tax advisors can exercise their profession in company form. If legal persons are admitted to practice, secondary questions arise, such as the control on the board of directors and the general meeting of shareholders by physical persons licensed to practice, the way legal persons participate in the life of the professional organization (voting rights in the general meeting of the profession, representation in the executive board, membership dues), and the way ethical rules are enforced against legal persons.

(10) Cooperation with other regulated and unregulated professions is also a problem to be dealt with. Conditions for cooperation on an individual basis or within the framework of a legal person should be spelled out, including the question of whether a person can become a member of more than one profession, as well as rules with respect to activities compatible with the exercise of the profession.

(11) The regulation should also deal with tax advice provided by employees in the service of their employer and tax advice for third parties. This is a specific problem because employees do not have the same guarantees of independence as independent licensed tax advisors.

(12) Full regulations may contain rules on ethical standards with regard to advertising, conflict of interest (particularly when tax advisors collaborate with other professions in the framework of a legal person), and limitations on financial interests in potential clients.

(13) Rules on professional privilege should be set down, when such professional privilege is granted to the tax profession.

(14) Rules on professional liability vis-à-vis customers and rules with respect to the obligation to carry professional insurance should also be spelled out.

(15) Some regulations contain a full schedule of fees.[55]

[54]*See supra* sec. I(E).

[55]*See supra* note 40.

(16) Last but not least, the regulation should contain transitional measures. These are very important because they will determine the balance between supply and demand during the early stages, when the professional regulation is taking effect. The balance between the flexibility of transitional regulations and the strictness of the final regime should be watched very closely. Too often tax practitioners succumb to the temptation of keeping the door wide open during the transitional regime, setting almost no meaningful standards for admission and slamming it shut after the transitional period, so that the established professionals are sitting pretty, while young and capable candidates are kept away by insurmountable entry barriers.

In the model of partial regulation, the extent of regulation is of course much more restricted. In the U.S. model, there is no place for an order or an institute, so that all rules with respect to such institutions become irrelevant. Many tax advisors will be governed by disciplinary rules applicable to their professions of law or accounting. Disciplinary rules for those admitted to practice before the tax authorities should be provided for in the regulation, to be enforced by the government. Because there is no monopoly, there are no problems to regulate with respect to the relationship with other professions. Anyone will be allowed to file tax returns and provide tax advice. There is protection of title, in the sense that persons who are not admitted to practice before the tax authority cannot use the title pertaining to those who are. Educational, professional, or other quality standards, including a minimal tax examination, will have to be provided for those admitted to practice before the tax authority. However, because practice in the form of preparing returns or offering tax advice will generally be open, these requirements will not keep out those who wish to practice without formal admission to practice.

Even when there is no regulation for the tax profession at all, there may still be some rules as to preparing tax returns, providing tax advice, and representing taxpayers before the tax administration and the courts. These rules are usually found in the general tax legislation. They deal with questions such as the liability of and sanctions against persons helping or advising the taxpayer in cases of fraud and tax evasion, the legal consequences of the use of outside services to fulfill personal tax obligations, and rules with respect to the question of who has standing to represent a taxpayer before the tax administration, the tax courts, and the courts of tax appeals.

E. Penalties for Practitioners

Whatever the degree of regulation a country wants to introduce for the tax profession, legislation should contain clear, comprehensive rules providing penalties for violations by tax practitioners. Tax practitioners who are lawyers,

accountants, or auditors are subject to discipline by the licensing authority of the jurisdiction in which they are licensed to practice. If the behavior of such a professional while acting in a tax matter runs counter to the standards of professional conduct of the jurisdiction, he or she is therefore subject to disciplinary punishment that can range from a reprimand to suspension or disbarment from practicing.

The above-described sanctions may not be tailored to tax practice and are applicable only to practitioners who are also lawyers, accountants, or auditors. Therefore, where persons are engaged in tax practice, regardless of whether it is regulated or not, there are typically additional sanctions that are tailored to taxation and that apply to all those engaged in tax practice. These sanctions may be contained in a specific professional regulation, but most often they are part of the general tax law. Typically, these rules will apply in cases of misbehavior, such as filing false returns or aiding a taxpayer in cases of fraud or tax evasion, and provide for criminal sanctions and a prohibition against representing taxpayers before the tax administration. For example, in the United States, the Treasury Department has issued regulations[56] governing practice before the Internal Revenue Service that contain rules for disciplinary proceedings and that allow the Treasury Department to disbar from practice before the IRS persons who violate the rules.

In addition to the specific penalties of suspension and disbarment provided under such regulations, tax laws may provide penalties for tax return preparers and others who engage in tax practice and who commit designated offenses, usually relating to specific tax returns.[57] This type of penalty is similar in structure to penalties applicable to the taxpayer (such as for late filing, late payment, negligence, or fraud) but is imposed directly on the preparer for the preparer's improper conduct. The penalty should not apply if the preparer is not at fault, for example, if the taxpayer fails to provide information to the preparer and the latter does not have reason to believe that the information reflected on the return is false.

For example, in the United States, a penalty applies to a return preparer who fails to sign the return. Code section 6694 imposes a penalty on a person who prepares an income tax return that reflects a position for which there was not a realistic possibility of being sustained and imposes a higher penalty for willful or reckless conduct in preparing a return. Of course, if the tax advisor's conduct is particularly outrageous, so that the advisor is an accomplice in tax evasion, then criminal sanctions may apply.

Regulation may also be accomplished by courts. For example, the rules of the U.S. Tax Court provide ethical standards for those practicing before it.[58]

[56]31 C.F.R. §§ 10.0–10.101 (USA).

[57]*See, e.g.*, Wolfman et al., *supra* note 7, §§ 301.1–305.3.

[58]*See* U.S. Tax Court Rule 201, 202, 60 T.C. 1153–54 (1973); U.S. Tax Court Rule 33(b), 85 T.C. 1125–26 (1985); Wolfman et al., *supra* note 7, at § 106.

Those engaged in tax practice who behave negligently may also be liable to their clients or to third parties in a civil action for negligence or breach of contract.[59]

In some countries, the tax advisor is held personally liable to the state for any taxes or penalties due in case of avoidance or evasion.[60] This model is not followed, however, in most countries. Except when the tax advisor himself breaks the law as an accomplice to the tax evasion of a client, the advisor should not be held personally liable for the taxes or penalties imposed on the client. The advisor should be subject only to specific penalties for his or her unlawful behavior.

IV. Legal Consequences of Using Advisors

A. Returns

In some countries, the law encourages or requires the use of qualified professionals in preparing returns on the theory that a return prepared by a professional will be on a sounder footing and less likely to be fraudulent. For example, if an alternative income tax is directed at businesses maintaining questionable (or no) accounts, the law may apply the tax generally and then provide an exception for companies maintaining audited accounts.[61] Most countries do not, however, provide special treatment for returns based on audited books.

In Israel, companies are required to submit income tax returns that are certified by an auditor, as defined in the Auditors Law, and that are adjusted by the auditor for the purposes of the tax.[62] In Turkey, taxpayers above a certain size are required to have their returns certified by a sworn fiscal advisor.[63]

B. Liability for a Tax Advisor's Mistakes

A tax return prepared by a registered tax preparer may give rise to penalties for reasons that are the fault of the tax preparer rather than of the client for whom the return was prepared. For example, the preparer may make errors

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[59] *See* Wolfman et al., *supra* note 7, at §§ 601–605; Geoffrey Lehmann & Cynthia Coleman, Taxation Law in Australia ¶ 11.74 (3rd ed. 1994).

[60] *See* Mustafa Çamlica, *Compulsory Return Certification and Sworn Fiscal Advisory in Turkey*, 10 Tax Notes Int'l 1584, 1586 (1995) (responsibility of sworn fiscal advisor for tax and penalties in respect of return certified by him or her); Luís F. Ramírez A., *Privatization of Tax Administration*, *in* Improving Tax Administration in Developing Countries 377, 388 (Richard M. Bird & Milka Casanegra de Jantscher eds., 1992) (in Mexico, accountant who certifies return is liable for penalties).

[61] *See* SLE IT § 23 (minimum chargeable income provisions do not apply where taxpayer's books of account have been audited by "a reputable firm of Accountants" and the Commissioner has conducted a satisfactory field audit).

[62] *See* ISR IT § 131(c).

[63] *See* Çamlica, *supra* note 60, at 1585.

or omissions that give rise to penalties, file the return late, and so forth. The question arises as to whether the taxpayer should be immune from penalty where the conduct giving rise to the penalty is that of a registered tax preparer.

This problem can be approached in one of three ways:

1. The taxpayer can be liable for penalties but retain the right available under the general law to sue the tax preparer under tort or contract law for recovery of the amounts.
2. The taxpayer can be liable for penalties but be protected by specific legislation that requires tax preparers to indemnify taxpayers.
3. The taxpayer can be excused from penalties arising out of errors or failures by a tax preparer; penalties may also be imposed directly on the tax preparer instead of on the taxpayer.

The rationale for the third approach is that a taxpayer who deliberately seeks professional advice and assistance, among other reasons, to avoid errors or omissions, should not then be penalized because of another person's inadequate performance. This position is strongly supported, perhaps surprisingly, by professional tax preparers in some jurisdictions. Where there is a "reasonable cause" exception to imposition of a penalty, the argument is that in relying on a professional, the taxpayer acted reasonably and therefore should not be penalized.[64]

The practical problem that would be encountered if the third approach were adopted is that of evidentiary dispute. It will often not be clear to revenue authorities who was to blame for the problem giving rise to a penalty, and these authorities cannot be expected to investigate and ascertain blame before levying a penalty.

While ordinary contract or tort law may be sufficient to protect a taxpayer if the third option is not considered feasible, a specific statutory remedy may be desirable to avoid any doubt about the matter.[65] Moreover, inclusion of such a measure in the tax legislation could be used as a means of bringing the action within the ambit of the tax litigation system and provide the parties with access to the tax appeal system, where they will encounter tribunals and courts with greater tax expertise and more knowledge about the technical problems that gave rise to the penalties in the first place.

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[64]*See* Saltzman, *supra* note 21, ¶ 7B.06[3][c]. Under U.S. law, the question can be framed as to whether reliance on professional advice constitutes reasonable cause that allows the taxpayer to escape from the penalty. In the case of a failure to file a return, the Supreme Court has decided that reliance on an advisor who failed to file cannot be considered reasonable cause. *See also* United States v. Boyle, 469 U.S. 241 (1985).

[65]*E.g.*, AUS ITAA § 251M. For a discussion of problems under this provision, *see* National Review of Standards for the Tax Profession, *supra* note 48, at 91–93. For a discussion of the tax advisor's liability for negligence and criminal liability under Danish law, *see* Anders Vinding Kruse and Jesper Lett, *Civil and Criminal Liability for Advice Pertaining to Issues of Taxation*, 33 Scandinavian Studies in Law 167 (1989).

As indicated above, in some cases penalties may be waived when the technical violation of the tax law was due to the fault or negligence of the tax agent. However, in most cases the taxpayer will remain liable to tax and interest. So, for example, if the tax advisor fails to file a tax protest in time, and on account of this negligence the taxpayer is not able to defend the taxpayer's case, the amount of tax assessed will be due from the taxpayer. The fact that the taxpayer used the services of a tax advisor is not an excuse for not filing the protest in time. The taxpayer will have to pay the full amount of tax and recover damages from the tax advisor in a court suit on professional liability. Any other rule would allow the taxpayer to use the tax advisor as an alibi for not playing by the rules of the tax law.

The use of a tax advisor may be seen as an attenuating circumstance, however, when the taxpayer is accused of tax evasion. The fact that the taxpayer used the services of a tax advisor is often seen as an indication that the taxpayer intended to fulfill all the taxpayer's tax obligations in accordance with the law, so that it becomes more difficult for the tax administration to accuse the taxpayer of tax evasion. This presumption is of course valid only when the taxpayer provided all necessary information to the advisor.

C. Facilities for Taxpayers' Use of Tax Advisors

Even when the profession of tax advisors does not have a monopoly on the provision of tax services, the legislator may recognize the advantage of having professionals prepare tax returns, thereby reducing the administrative burden for the tax administration. The regulations may provide for some facilities that are available only to licensed professionals. These may include the following: automatic acceptance of credentials as an attorney for the taxpayer, flexible rules with respect to the filing of tax returns and payment of the taxes due, and informal ways of communication between the tax advisor and the tax administration.

Appendix A.
Organization of Tax Profession in Different Countries[66]

In countries such as Belgium, Italy, the Netherlands, Spain, and the United Kingdom, there are one or more private associations representing tax consultants without formal legal status. In Denmark, Greece, Ireland, Luxembourg, and Portugal, tax advisors either are not organized professionals or are members of other professional organizations, such as accountants, auditors, or lawyers, who also engage in tax activities. Germany and Austria have a profes-

[66]The discussion is based on Ottmar Thoemmes et al., EG-Recht in der Steuerpraxis (1993); and Wilfried Dann, *Das Leistungsspektrum des Steuerberaters in Europa und seine berufsrechtlichen Grundlagen*, Internationales Steuerrecht 44 (1993).

sion that is specifically regulated, with associations of tax professionals that are recognized by law. In France, tax advice that constitutes the provision of legal advice is regulated as part of the legal profession.

The following table lists tax professionals for each country discussed:

Tax Professionals in Selected Countries

Australia	lawyer, accountant, tax agent
Belgium	conseil fiscal, avocat, reviseur d'entreprise, expert comptable[1]
Canada	lawyer, accountant
France	comptable, expert-comptable, avocat
Germany	Steuerberater, Rechtsanwalt, Wirtschaftsprüfer, vereidigter Buchprüfer, Steuerbevollmächtigter
Italy	tributaristo, avvocato
Netherlands	belastingadviseur, belastingconsulent, advokaat, register accountant
Spain	asesor fiscal, abogado, economista
United Kingdom	accountant, tax consultant, taxation practitioner, lawyer
United States	accountant, attorney, enrolled agent

[1]Belastingconsulent, belastingadviseur, advocaat, bedrijfsrevisor, accountant.

In Australia, tax returns may generally be prepared for remuneration only by a tax agent or a lawyer. Tax agents are defined in legislation and are regulated by a board controlled by the tax authorities. Tax agents and lawyers may also represent taxpayers in administrative disputes, but only lawyers may represent taxpayers in court litigation.

In Belgium, a tax advisor is called *belastingconsulent-conseil fiscal*. This professional designation is not regulated by law, nor does the law regulate who may give tax advice, but there is a private professional organization to which tax advisors typically belong. Tax advice can also be given by lawyers (*advocaten/avocats*), notaries (*notarissen/notaires*), accountants (*accountants/experts-comptables*), or auditors (*bedrijfsrevisoren/reviseurs d'entreprises*), the latter being analogous to a certified public accountant. All these professions (lawyer, accountant, and auditor) are recognized and regulated by law, but typically the provision of tax services is outside the scope of this regulation. However, anyone may prepare a tax return and represent the taxpayer before the tax administration or in administrative disputes. Tax litigation before the civil courts is limited to lawyers. Except for accountants and auditors, there is incompatibility between some professions; that is, a lawyer cannot be a tax advisor, and a lawyer cannot be an auditor, but both are entitled to provide tax services.

In France, tax advice was traditionally indirectly regulated as part of legal advice in general.[67] The legal profession was divided into *avocats* and *conseils*

[67]*See* Loi No. 71-1130 of Dec. 31, 1971, portant réforme de certaines professions judiciaires et juridiques, J.O. Jan. 5, 1972 [hereinafter Loi No. 71-1130].

juridiques (legal advisors). However, legal advisors did not have a monopoly on the provision of legal advice, so that tax services were also provided by notaries (*notaires*), accountants (*comptables*, *experts-comptables*), and auditors (*commissaires aux comptes*). France also had a specialized certification for tax lawyers: *avocat spécialiste du droit fiscal*. Recently, all legal activities, including litigation, legal advice, and tax advice, were merged into a new profession whose members carry the title of *avocat*.[68] The provision of tax advice that constitutes legal advice is regulated as part of this legal profession. The French regulatory scheme provides for a monopoly on legal advice for people holding a professional degree in law.[69] Legal persons are also admitted to the profession, provided they meet certain conditions, which guarantee that physical persons who are admitted to the profession will control the legal person.[70] The law also sets criteria for obtaining the title of lawyer (*avocat*) that are more stringent than the conditions formerly imposed to practice as a legal advisor.[71] The legal profession is fully organized as a bar, with disciplinary proceedings, professional privilege, and rules of ethical conduct. All the rules that apply to lawyers also apply to tax consultancy insofar as it is a subdivision of legal advice. However, other professions, such as *experts comptables* (chartered accountants), may also provide tax advice, provided that it is in direct relationship to the services (*e.g.*, accountancy) that they provide their clients.[72]

Germany (as well as Austria) is one of the few countries that has a long-established legal organization of the tax consultancy profession. The law provides a monopoly for tax advice and prohibits unauthorized persons from providing tax services.[73] The German law extensively regulates services relating to the administration of withholding taxes and social contributions on salaries.[74] It contains provisions for a full professional organization, with conditions for admission, quality and educational requirements, admission of legal entities, control of legal entities by physical persons admitted to the profession, disciplinary proceedings, ethical rules, and obligations and rights and privileges of tax consultants.

The Italian term *tributaristi* includes members of several professions: including lawyers, *dottori commercialisti*, *ragioneri*, and *notarii*. All of these profes-

[68]*See* Loi No. 90-1259 of Dec. 31, 1990, portant réforme de certaines professions judicaires et juridiques, J.O. Jan. 5, 1991 [hereinafter Loi No. 90-1259].

[69]"Nul ne peut, directement ou par personne interposée, à titre habituel et rémunéré, donner des consultations juridiques ou rédiger des actes sous seing privé, pour autrui: 1° S'il n'est titulaire d'une licence en droit ou d'un titre ou diplôme reconnu comme équivalent par arrêté. . . ." *Id.* art. 26.

[70]This question is regulated in a separate law. *See* Loi No. 90-1258, *supra* note 15.

[71]*See* Loi No. 90-1259, *supra* note 69, art. 9.

[72]*See id.* art. 59; Décret No. 91-1197 of Nov. 27, 1991, organisant la profession d'avocat, J.O. Nov. 28, 1991.

[73]*See* DEU StBerG §§ 3, 4, 5, 160.

[74]*See* DEU StBerG §§ 13–31.

sions are regulated by law, but *tributaristi* can also be tax advisors who are not licensed professionals, because there is no monopoly on tax advice. Representation of taxpayers before the civil courts is limited to lawyers.

In the Netherlands, the profession of tax advisor is not regulated by law. Tax services are provided by a wide range of professions, all of which (except for tax advisors) are regulated by law: lawyers (*advocaten*), notaries (*notarissen*), accountants and auditors (*register accountants*), and tax advisors (*belastingconsulenten* or *belastingadviseurs*). However, the part of their activities that consists in providing tax services is not regulated. There is no incompatibility between the other professions and the tax advisors; that is, a lawyer or an accountant can at the same time be a tax advisor. The situation of tax advisors is unique in that, although the professions are not recognized by law, the two private organizations of tax advisors (NOB and NFB)[75] are so strong and prestigious that it is almost impossible to engage in tax services in the Netherlands without belonging to one of them. Both organizations use high professional standards for admission and strict ethical rules. The NOB requires an academic degree for membership and the NFB requires a rigorous training program with strict examinations.

In Spain, a tax advisor, called *asesor fiscal*, might be a lawyer (*abogado*), accountant (*economista*), or holder of a degree in business (*professor mercantil*, *intendente mercantil*). Again, the provision of tax advice is not restricted to particular professionals. Anyone can file a tax return for remuneration. However, tax litigation in civil courts is restricted to lawyers.

In the United Kingdom, tax advisors are typically known as accountants, tax consultants, or taxation practitioners, but there is no legal limitation on the general provision of tax advice. More and more solicitors are entering the field of tax advice. In the United Kingdom, external auditors, solicitors, and barristers are subject to regulations, but these do not specifically regulate tax advice. Anyone is free to prepare tax returns and to represent taxpayers before the tax administration or the tax commissioner on appeal from assessment. Only barristers can represent a taxpayer before the High Court.

Similarly, in the United States, tax advice may be given by lawyers, accountants, enrolled agents (i.e., those admitted to practice before the IRS), or those without professional certification. There is a kind of factual division of labor whereby ordinary tax returns are prepared by enrolled agents or by unregistered preparers, while more complicated cases are handled by lawyers or accountants.

[75] *See supra* note 1.

6

Value-Added Tax

David Williams

> Not only is the VAT a fairly simple tax, but it is also probably the most popular tax in the world today.
>
> —*Mark Bloomfield and Margo Thorning*

> The concept of value added is not clearcut or easily defined. . . . On the whole, the value-added tax is not nearly as simple a levy as is sometimes argued.
>
> —*John F. Due*

I. Introduction

A. Adoption of VAT

Value-added tax (VAT) is still a relatively new tax. It was first introduced as a comprehensive national tax 40 years ago in France.[1] Since then, it has been adopted as the main form of indirect taxation by many countries in different parts of the world and at different stages of economic development.[2] In particular, it

Note: This chapter was produced in parallel with a draft law (the "Draft Value Added Tax Law of the Republic of Fiscalia," accompanied by a commentary). My thanks for help over several years on this chapter, the related papers, the thinking that lies behind them, and the draft law are due in particular to Victor Thuronyi, Richard Vann, and Robin Adair. Frans Vanistendael gave invaluable comments about Western European laws and detailed comments on the entire text. Thanks are also due to my colleagues and students at the University of London, including particularly Nuala Brice, Adrian Shipwright, Gloria Teixeira, Panit Dhirapharbwongse, Junko Isonako, and Carolina Gratenol.

[1]The *taxe sur la valeur ajoutée* was introduced in 1954. For a discussion of its antecedents and evolution, *see* 1 Direction générale des impôts, Précis de fiscalité [*généralités*: two pages preceding ¶ 2000] (1994). The current legislation is in *Titre II*, *Chapitre premier* of the *Code général des impôts*. FRA CGI art. 256 *et seq*.

[2]For a thorough survey, *see* Alan Tait, Value-Added Tax: International Practice and Problems (1988). Since 1988, several of the countries that did not then have a VAT have adopted one. None of the states with a VAT described in Tait, *supra*, has repealed it. On the contrary, the general trend has been to increase the rates of VAT and reduce the exceptions.

is a key common form of taxation for the 15 member states of the European Union.[3] It has also been adopted by Japan,[4] China,[5] Canada,[6] Korea,[7] and many other states in Asia, North and South America, and Africa, besides being adopted in almost all the states of Europe[8] and of the former Soviet Union.[9] Further, the process of expansion of the European Union, together with the alignment of the laws of potential candidates for membership, has ensured increasing consistency in the form of VAT operating in

[3]All EU member states are required to apply the agreed provisions of VAT. The key legislation is found in a series of directives and regulations of the European Union, of which the most important are the First Council Directive 67/227 of Apr. 11, 1967, on the Harmonisation of Legislation of Member States Concerning Turnover Taxes, 1971 O.J. (L 71) 1301 [hereinafter the EC First VAT Directive] and the Sixth Council Directive 77/388 of May 17, 1977, on the Harmonisation of the Laws of Member States Relating to Turnover Taxes—Common System of Value Added Tax: Uniform Basis of Assessment, 1977 O.J. (L 145) 1 [hereinafter the EC Sixth VAT Directive]. For a detailed analysis of this legislation and other relevant aspects of EU law, *see* B.J.M. Terra & Julie Kajus, VAT Legislation of the European Union (1995).

[4]Best termed in English the consumption tax, this tax has a number of special features compared with the tax outlined in this chapter, but it is in essence a tax on value added of the kind discussed here. For a full account in English, *see* Ministry of Finance, An Outline of Japanese Taxes 141–75 (1994). *See also* Alan Schenk, *Japanese Consumption Tax After Six Years: A Unique VAT Matures*, 11 Tax Notes Int'l 1379 (1995).

[5]The People's Republic of China has had a limited form of VAT for some years, but has recently revised and broadened the tax. The current legislation is in Provisional Regulations of the People's Republic of China on Value-Added Tax, adopted by the State Council on Dec. 13, 1993 (CHN VAT), and supplemented by rules for its implementation. Ministry of Finance, Detailed Rules for the Implementation of the Provisional Regulations of the People's Republic of China on Value-Added Tax (Dec. 25, 1993), *reprinted in* Foreign Taxation Administration Department, National Taxation Bureau, A Collection of Tax Laws and Regulations of the People's Republic of China 109 (1994)(in Chinese with English trans.).

[6]The "Goods and Services Tax" (CAN GST) was adopted in 1990 and entered into force on January 1, 1991. It was based on the New Zealand Goods and Services Tax (NZL GST), first adopted in New Zealand in 1985. Major reform of the structure and details of the Canadian tax is currently under consideration.

[7]The tax, translated in English as the value-added tax, was adopted in the Value-Added Tax Law of 1976 (KOR VAT). It broadly follows a simplified version of the form then taken by the VAT in the European Communities (now the European Union).

[8]With the exception of territories of the former Socialist Federal Republic of Yugoslavia, a VAT has now been adopted, or is being considered for adoption, by every state in Europe save some of the smallest. One of the more significant states to adopt a VAT recently is Switzerland, where the population rejected the adoption of the tax at three plebiscites, but agreed to it at a fourth. The Swiss law (French version) is the Ordonnance régissant la taxe sur la valeur ajoutée, of June 22, 1994. The Swiss law broadly follows the form of VAT adopted in the European Union.

[9]The Russian form of VAT (RUS VAT) and those of some of the other countries of the former Soviet Union raise a number of special issues, including relations within the Commonwealth of Independent States. For an analysis of some of these issues, *see* Victoria P. Summers & Emil M. Sunley, *An Analysis of Value-Added Taxes in Russia and Other Countries of the Former Soviet Union*, IMF Working Paper 95/1 (January 1995).

Europe.[10] Of the major economies, only the United States and Australia[11] do not have a VAT at the federal level (partly because of problems in introducing the tax in federal states), although both have considered in detail how it might be implemented.

As a result of this rapid and widespread adoption of a VAT, the laws implementing the tax have adopted different terms and forms in different states. Tait has rightly described it as an "unparalleled tax phenomenon."[12] There has therefore been little chance to evolve a settled vocabulary or considered common approach.[13] In particular, there is no international organization with the specific role of supervising the operation of value-added taxes among states in the way that the Fiscal Affairs Committee of the Organization for Economic Cooperation and Development (OECD)[14] keeps an eye on double taxation agreements and the International Customs Union (formerly Customs Cooperation Council) coordinates the collection of customs duties. Although the European Commission performs that function within the European Union,[15] and assists elsewhere in Europe,[16] it does not have competence to act globally.

[10]The requirements set out in the directives noted in note 3 *supra* apply to all member states, and candidate members are required to amend their law to conform with it by the time of membership. At the European Council of Ministers conference at Cannes in June 1995, the Council adopted a Commission White Paper laying down terms for convergence toward entry. Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union: White Paper Presented by the Commission, COM (95)163 final. It includes detailed steps to bring indirect taxes in line, particularly, with the requirements of the VAT Directives. *Id.* at Annex. In effect, the terms amount to an early adoption of the principles of the EU form of VAT and a staged adjustment of national laws until all EU requirements are met. The guidance applies specifically to Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic, and Slovenia, but by analogy applies to other European states as well. *Id.* ¶ 1.15.

[11]The tax has been actively considered in both states. In the United States, the American Bar Association produced a detailed report and draft law. *See* Committee on Value Added Tax, Section of Taxation, American Bar Association, Value Added Tax: A Model Statute and Commentary (Alan Schenk reporter, 1989). *See also* 3 U.S. Treasury Department, Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President (1984). In Australia, the tax was discussed at the government level but rejected after lengthy political debate.

[12]Tait, *supra* note 2, at 3.

[13]*See* Ward M. Hussey & Donald C. Lubick, Basic World Tax Code and Commentary: 1996 Edition, at Title II ("Value Added Tax") (1995)(containing a draft VAT law). The Basic World Tax Code follows the U.S. federal style of drafting (although, of course, the United States does not have a VAT), but is based largely on the same principles as the VAT addressed in this chapter.

[14]However, the Fiscal Affairs Committee of the OECD has in recent years taken a role in monitoring some aspects of VAT within its member states and in the states of Central and Eastern Europe and the countries of the former Soviet Union. It also published a thorough survey of the use of the VAT and similar taxes by the member states of the OECD in 1988. Organization for Economic Cooperation and Development, Taxing Consumption (1988). More recently, it has held regular informal VAT workshops for government officials as part of its program of technical support to the states of Central and Eastern Europe and the countries of the former Soviet Union.

[15]VAT is the responsibility of Directorate-General XV of the Commission.

[16]This assistance is provided by officials and consultants through the PHARE and TACIS funds of the EU.

Nonetheless, despite varying names and terminology, the VAT has a common core form throughout the world. That is the focus of this chapter.

The aim of this chapter is to examine in detail the legal structure required to implement a broad-based VAT and to draw attention to legal problems requiring solution for the efficient introduction of the tax. The discussion is mainly restricted to the invoice-based credit method of the consumption-type VAT. This is by far the most prevalent type of VAT in use, although there are other forms in existence[17] or as a matter of theory. The chapter does not seek to explore the policy behind the VAT or assess its relative merits as a form of taxation.[18]

B. Terminology

The rapid emergence of the VAT, together with the new concepts involved in the tax, has meant that states have had to invent new words to deal with the tax. Inevitably, these terms have proved inconsistent, even among countries that share a common language. Since the terminology used in a VAT law is instrumental in ensuring the effective working of the law, it is most important that the terminology to be used in any law be considered thoroughly.

For that reason, it is important to note the terms used in this chapter and why they have been chosen. The vocabulary is increasingly used in discussions in English. However, there is no standardized English usage, and the text indicates alternatives where they may help to clarify the underlying concepts. It must also be borne in mind that some of these terms do not translate well into other languages. Consequently, variations occur because of the absence of a common vocabulary.

The name "value-added tax" is not a universal term. The term exists in two English forms: "value added tax" and "value-added tax."[19] Both represent a translation of the original French term,[20] and it might be argued that

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[17]The most important example of another kind of VAT is the accounting method consumption tax adopted in Japan. *See* Ministry of Finance, *supra* note 4, at 141, 170–74. This simple form of the tax emerged from the compromise necessary to meet strong opposition when the tax was introduced. It is based on book entries as well as on invoices.

[18]This has been done in Alan Tait's important book, *see* Tait, *supra* note 2. *See also* Sijbren Cnossen, *Key Questions in Considering a Value-added Tax for Central and Eastern European Countries*, 39 IMF Staff Papers 211 (1992); Value Added Taxation in Developing Countries (Malcolm Gillis et al. eds., 1990); Howell H. Zee, *Value-Added Tax*, *in* Tax Policy Handbook 86 (Parthasarathi Shome ed., 1995). For an introduction to VAT policy, the reader may wish at this point to read sec. II of ch. 7.

[19]The former is the style used in the United Kingdom, GBR VAT, and in the English-language versions of EU legislation. *See supra* note 3. The latter is used by Ireland, South Africa, and in the English translations of the laws of a number of states.

[20]The French name is *taxe sur la valeur ajoutée*. The German name is *Mehrwertsteuer* (added-value tax) or *Umsatzsteuer* (turnover tax), the latter being the formal name of the tax under German law. The Spanish name is *impuesto sobre el valor añadido* (*valor agregado* in some Latin American countries).

"added value tax" would be the nearest version, but this is not used. Other states use "goods and services tax." As already noted, this chapter uses the abbreviation "VAT" throughout.[21] The term VAT is preferred to "goods and services tax" or other names because it most accurately reflects the unique nature of this tax.

One example of a term that causes language problems is "supply." The transactions taxed by a VAT are usually termed "supplies" in English-language texts.[22] The term does not translate easily and directly into French, German, Russian, or Spanish. Nor have those languages evolved a single term equivalent to "supply." For example, the French law refers to *les livraisons de biens meubles et les prestations de services*. Consequently, this key term cannot be used in states using those languages. Similar problems are encountered in Japan, where the law refers to "transfers of assets, etc."

A second example is the link between the term "supply" and that of "goods or services." In some laws, the emphasis is separately placed on "supply" and "goods and services," while in others—for reasons just noted—the focus is on "supply of goods" and "supply of services." Again, English usage is not itself entirely consistent,[23] but problems arise in other languages both over this point of linkage and also with the terms "goods and services."[24]

A final example shows language reflecting underlying differences in legal systems. The example is the next phrase in the EU version of the charge to VAT, namely that the tax is imposed on "the supply of goods or services *effected for consideration*."[25] The term "consideration" carries a particular technical meaning in common law states where it forms a constituent element in the

[21]This abbreviation (or its equivalent in the relevant language) is now also used in some national legislation. *See, e.g.*, the recent U.K. consolidation measure, the Value Added Tax Act, 1994, ch. 23 (GBR VAT)(referring to "VAT" throughout).

[22]This is the term used in the English version of the European Union directives, *supra* note 3, and in the VAT laws of the United Kingdom, GBR VAT §1, and Ireland, IRL VAT §§ 3, 5. It is also used in Canada, CAN GST § 123(1); New Zealand, NZL GST § 5; South Africa, ZAF VAT §§ 1(lvii), 9; and other English-speaking states. The problem is partly sidestepped in the Basic World Tax Code draft of Hussey and Lubick, *supra* note 13, which focuses on "taxable transactions." *Id.* §§ 201, 211. However, it also uses the term "supply" throughout. *Id.* § 212(c). *See also* the official English translation of the Bulgarian VAT Act of 1993, which refers to "transactions with goods and services." BGR VAT art. 1. The term used in art. 4(1) of the Japanese Consumption Tax best translates as "transfer." *See* Ministry of Finance, *supra* note 4, at 141. VAT laws in the Russian language typically use the term *oborot* (turnover). RUS VAT arts. 3, 4; KAZ TC art. 54.

[23]Hussey & Lubick, *supra* note 13, talk of "goods or a service." *Id.* §211(a)(1). Like other English-speaking lawyers, they find it difficult to use the term "a good" despite its prevalent use among economists.

[24]As noted below, the Russian law and other laws similar to it refer to "goods, work, and services" because the term "services" has a narrower meaning in Russian than the concept expressed by the English word. *See* RUS VAT arts. 1, 3.

[25]EC Sixth VAT Directive, *supra* note 3, art. 2(1).

legal formation of a contract.[26] The term does not carry the same significance in states of the civil law tradition and cannot be directly translated. The French term is *effectuées à titre onéreux.*[27] It might be translated better as "against payment."[28] This approach is used in this chapter, although alternative approaches to avoid the term are used in some states.[29]

C. Economic Scope

The unique nature of the VAT is its potential scope in identifying and taxing the economic contribution—or added value—made by any economic operator in connection with any activity of a business or commercial nature. There are several ways in which that result can be achieved, as Tait discusses.[30] This chapter discusses only one, the method often called the invoice-based method, which is the most widely used. It requires the VAT to be identified in respect of each transaction or group of transactions.

The formal principles of this method are set out in the EC First VAT Directive[31] as follows:

> The principle of the common system of value added tax involves the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, whatever the number of transactions that

[26]This caused problems in the English courts in the case of Customs and Excise Commissioners v. Apple and Pear Development Council, [1984] Simon's Tax Cases [S.T.C.] 296 and [1985] S.T.C. 383, where the lower courts mistakenly focused on the technical English law meaning of the term, but questioned by the House of Lords, [1986] S.T.C. 192, and referred by them to the Court of Justice of the European Communities, which court, [1988] S.T.C. 221, emphasized that the term had common meaning throughout the European Communities (now the EU). The case well illustrates the dangers, emphasized here, of wrong terminology in this tax.

[27]Deuxième Directive 67/228 du Conseil du 11 avril 1967 en matière d'harmonisation des législations des Etats membres relatives aux taxes sur le chiffre d'affaires—Structure et modalités d'application du système commun de taxe sur la valeur ajoutée, art. 2, 1967 J.O. (L 1303) 67, 68; *see also* FRA CGI art. 256; CHE OTVA art. 4.

[28]This is the English-language text used in the (now superseded) Second Council Directive 67/228 of Apr. 11, 1967, on the Harmonisation of Legislation of Member States Concerning Turnover Taxes—Structure and Procedures for Application of the Common System of Value Added Tax, art. 2(a), 1967 O.J. (L 71) 1303, as an alternative English equivalent of the French phrase in the text (which did not change between the Second and Sixth EC VAT Directives).

[29]The New Zealand goods and services tax is imposed on supplies "by reference to the value of [the] supply." NZL GST § 8. A similar approach is taken in the Basic World Tax Code. Hussey & Lubick, *supra* note 13, § 221(a). The U.K. legislation links the concepts in a different (and, in the view of this writer, a less satisfactory) way by defining "supply" as including "all forms of supply, *but not anything done otherwise than for a consideration*." GBR VAT § 5(2)(a)(emphasis added). A difficulty with any such formulation is that some supplies that are not for consideration are taxable—for example, personal use of business assets—requiring a reference to deemed consideration.

[30]Tait, *supra* note 2, at 4–9.

[31]First VAT Directive, *supra* note 3, art. 2 (in part). The First VAT Directive provides the framework for the single form of VAT adopted by the European Union. *Id.*

take place in the production and distribution process before the stage at which tax is charged.

On each transaction, value added tax, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of value added tax borne directly by the various cost components.

The following is a simplified example of the operation of the VAT on these principles, involving X (who creates an item of household goods from raw materials acquired without costs), Y (who runs a shop and buys the goods direct from X to sell to the public), and Z (the customer who buys the goods for personal use). X sells the item to Y for $100 (ignoring the VAT), and Y sells the item to Z for $300. The value added by X is therefore $100 and by Y is $200. X and Y are both fully registered for the VAT. The rate of VAT is 10 percent.

X sells the item to Y for $100. The sale is subject to VAT at 10 percent, so X must add this to the price. Y therefore pays $110. X must account to the tax authorities for the VAT, $10, keeping a profit of $100. Y therefore pays $110 for the item.

Y sells the item to Z for $300. The sale is subject to VAT at 10 percent, so Y must add this to the price. Z therefore pays $330. Y is entitled to be paid back for the VAT paid out to X, so retains $10 of the VAT collected. Y must account to the tax authorities for the other $20, keeping a profit of $200. Y's profit remains at $200 because the net cost of Y buying from X is $100, not $110.

The tax authorities receive $30 in total, $10 from X and $20 from Y. This reflects the value added by both X and Y.

Further, assume that Z is also a trader registered for VAT and buys the item from Y for $300 plus VAT. However, Z is unable to sell the goods for a profit, and instead sells them to another private customer, W, for $280 plus VAT.

Z therefore pays $330 for the item. Z sells the item to W for $280. The sale is subject to VAT at 10 percent, so Z must add this to the price. W therefore pays $308. Z is entitled to be paid back for the VAT paid out to Y, so retains the full $28 VAT collected. Further, Z is due a rebate of $2 against other sales. Z will therefore claim a rebate of $2 from the tax authorities.

In this example, X and Y both added value on their sales. Z lost value. The tax authorities receive $10 from X and $20 from Y but must rebate $2 to Z. This totals $28 across the transaction as a whole, ensuring that the proper amount of VAT is paid. Note that if Z is not allowed a rebate (or, as in some of the countries of the former Soviet Union, if Z's loss is not recognized for VAT purposes), then the tax on the combined transactions is excessive.

D. Territorial Scope

Because the VAT is an indirect tax focusing on the transaction or activity rather than on the economic operator, the primary determination of

the territorial scope of the charge to VAT is by reference to the location of a transaction. If the transaction occurs within the state, then it is within the charge to VAT. Attention must also be paid to the person to be charged to VAT on the transaction, to ensure that the amount of VAT due can be enforced and collected. It is therefore necessary to provide rules to determine the identity of the person responsible for payment of the VAT when some element of the transaction being taxed takes place outside the jurisdiction of the state.

There are two conflicting principles on which the territorial scope of a VAT can be based: the *origin principle* and the *destination principle*. As these names suggest, the origin principle charges a transaction, only part of which occurs within the jurisdiction, if the transaction originates or is created within the state, and the destination principle charges the transaction if it is destined for consumption in the state. For example, if goods are exported from state *A* to state *B*, then state *A* will charge the transaction if it has an origin-based VAT, and state *B* will charge if it has a destination-based VAT. For services, it may in practice be harder to determine where the service is provided, or where it is consumed. Subject to that practical problem, an origin-based tax will concentrate on the state of origin of the person supplying the service, while a destination-based tax will charge supplies consumed in the state.

Potential problems of double taxation and absence of taxation arise if these rules clash. For example, assume state *A* has an origin-based VAT and state *B* has a destination-based VAT. Exports from state *A* to state *B* will be taxed in both states. Exports from state *B* to state *A* will not be taxed in either state. The result, in a free market, would be that goods from state *A* would be too expensive to be competitive in the market in state *B*, so only limited exports would occur. However, there would potentially be high levels of exports from state *B* to state *A* because the goods imported from state *B* would be tax free, while locally made goods in state *A* would be subject to tax. In practice, state *A* could not afford this imbalance and would impose a charge on the goods from state *B*—in other words, a destination-based charge, unless the charge is to be a discriminatory border charge. This would avoid the absence of a VAT, but not the double taxation. (An alternative adjustment mechanism, whose implications are beyond the scope of this book, is the exchange rate between the currencies of *A* and *B*.)

To avoid double taxation, states that impose a VAT on imports remove exports from the charge to tax (and conversely, they should exempt imports where exports are taxed). This will also remove double taxation if both states have the same system (whether the origin system or the destination system). The example shows that those sets of rules cannot in themselves deal with a situation where the two states have different approaches to this question.

There is no international agreement either determining that states should follow one of these principles rather than the other or seeking to

reach common rules to avoid double taxation (or double exemption from taxation). There is, therefore, no commonly agreed set of answers to these issues.

In practice, however, and with limited exceptions,[32] states have adopted the destination basis as the primary basis. There are some cases where, within a customs union or trading bloc, the origin basis is used or has been proposed for adoption,[33] but these practices are limited exceptions to the general approach. In this chapter, we therefore assume that the VAT is to be based on the destination principle. This requires a charge to VAT on all transactions occurring within the state and also on all imports to the state.

To impose tax on both groups of transactions, VAT is normally imposed by two parallel sets of provisions:

(1) provisions imposing VAT on all transactions within the state; and

(2) provisions imposing VAT on all transactions involving imports to the state.

This pattern is adopted in this chapter, and the question of taxation of imports is dealt with separately from the matter of transactions treated as fully within the territorial scope of the tax.

E. Internal Charge to VAT

The common pattern of an invoice-based VAT is that a charge to VAT is imposed on all transactions within the state and within the scope of the VAT. Each taxable person is allowed a deduction against the total VAT charged by the person to take account of any VAT paid by the person on inputs related to transactions within the scope of the VAT.

A transaction within the scope of VAT and on which VAT is imposed is commonly called an *output* and the VAT collected on it is called *output tax*. A transaction made to the person making the output is known as an *input*,[34] and the VAT paid by that person when obtaining the input is an *input tax*. The internal charge to tax, consistent with the principles noted above, is therefore a charge amounting to the output tax received by a person less the input tax paid by that person.

The charge to tax must therefore identify on which outputs, and by which persons, output tax must be collected, and what input tax is available as a deduction against that output tax.

[32] The main exception is that of Russia and states within the Commonwealth of Independent States, adopting an origin basis. *See* Summers & Sunley, *supra* note 9, at 26 *et seq*.

[33] The European Commission has formally proposed that the European Union change from the present destination basis to a form of origin basis, originally for 1997 for transactions within the EU, although that date has now been deferred. *See* 1990 O.J. (C 176) 8. At present, no consensus exists to take this proposal forward on a general basis.

[34] From the supplier's point of view, it is an output.

The normal approach is to impose output tax on transactions and persons if

(1) the transactions are "supplies of goods and services";[35]
(2) those supplies are "taxable" and not exempt from VAT;
(3) those taxable supplies are made by a "taxable person," that is, a person within the scope of the charge to VAT; and
(4) the taxable person makes those supplies as part of the person's business activities, and not as part of a hobby or noncommercial activity.

Each aspect of this approach to charging VAT is examined below.[36]

F. Approach to Charging VAT on Imports

States have normally adopted the practice of treating imports of goods separately from imports of services. Imports of goods are identified by the physical entry of the goods. Services cannot be identified in this way. Instead, states have chosen to adopt rules that treat a supply of a service as occurring within a state if the supply meets certain criteria (and not so occurring if it does not). In this way, states have usually avoided the concept of "import of services" by defining or deeming services to be supplied either in the state or outside it (and not "to" it).[37] This is the approach adopted in this discussion.

Having identified imports of goods as a separate occasion for charge, the normal practice of states is to use their customs laws as a vehicle for imposing the VAT on goods that are imported, subject to necessary modifications. The nature of appropriate modifications is discussed below.

G. Principle of Nondiscrimination

The existence of separate charges on locally supplied goods and imported goods gives rise to the possibility of discrimination between the two classes of supplies. Most states are obliged by international agreement not to discriminate against supplies by way of import. The primary source of this obligation is

[35]The summary adopts the terminology used in this chapter. Note, however, the reservations against any particular set of words already noted above.

[36]*See infra* secs. II–IV.

[37]The distinction is not merely semantic. An import of goods is taxable regardless of the identity of the supplier or person supplied. By contrast, an "import" of services is taxable only if the supplier (or person supplied) is a taxable person. Since there is usually a registration threshold for VAT, a foreign supplier that supplies only services with a low annual value may not be a taxable person. In the case of imported goods, the importer is made liable for the VAT regardless of that person's status. In the cases of services, the person receiving the services may be responsible for the VAT under a reverse charge (*see infra* text accompanying note 89), but registration will still be required for this to be effective.

Article III of the General Agreement on Tariffs and Trade.[38] The key part of that article provides:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products.

A growing number of states are also under other obligations not to discriminate through their indirect taxes. Sources of such obligations include the terms of customs unions and free trade area agreements,[39] double tax agreements,[40] and bilateral trading and investment agreements.[41] The principle therefore requires some modifications of customs law (which is in its essence a charge designed to discriminate). This is also discussed below.

To ensure that a state complies with these obligations, the structure of its VAT must be nondiscriminatory. This requires that the imposition of VAT on imports of goods or on services originating outside the state must not be in excess of the charge on internal transactions.

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[38]Text adopted in 1947. The GATT 1947 (as amended before 1995) along with various protocols, decisions, waivers, and understandings make up the GATT 1994. Therefore, the obligation remains valid. Indeed, its scope is potentially widened to cover some services as well as products (or goods—the terms are effectively interchangeable).

[39]An example is art. 95 of the Treaty Establishing the European Community (and directly operative in all the member states of the EU). This imposes an obligation on all member states not to use internal taxation of products to favor locally produced goods over similar goods from other member states, or so as to cause indirect discrimination of that kind. The article has led to considerable litigation within the EU and before the European Court of Justice. *See* Stephen Weatherill & Paul Beaumont, EC Law, chs. 6, 14 (1993).

[40]Article 24 of the OECD Model Tax Convention on Income and on Capital of 1992 [hereinafter OECD Model Tax Convention], *reprinted in* Philip Baker, Double Taxation Conventions and International Tax Law (2d ed. 1994), contains a provision prohibiting discrimination between the two states that are parties to the agreement with respect to the nationality of taxpayers. Although most provisions in the OECD Model Tax Convention are confined to direct taxes, art. 24(6) applies this article to all forms of tax. Therefore, it potentially covers the VAT.

Article 24 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries contains a provision that is identical to an earlier version (the 1977 version) of the OECD Model Tax Convention. UN Dep't of Int'l Economics & Social Affairs, UN Model Double Taxation Convention Between Developed and Developing Countries at 39, 207, UN Doc. ST/ESA/102, UN Sales No. E.80.XVI.3 (1980). The only differences with the present OECD provision are drafting changes. Baker, *supra*, at 384. The model form of wording is found widely in individual double taxation conventions, although some states do not adopt it. The United Kingdom recorded a reservation to paragraph 6 in the OECD Model Tax Convention commentary, but no other state has done so. *Id.* at 413.

[41]The earliest nondiscrimination clauses (usually in the form of national treatment clauses or most-favored-nation clauses) are in treaties of friendship, commerce, and navigation, some of which were first negotiated in the fifteenth century. Many friendship, commerce, and navigation agreements are still in force. The modern practice is to negotiate bilateral investment protection agreements. These sometimes include similar clauses.

II. Taxable Persons

A. Persons Within the Scope of the Law

A person within the scope of VAT is usually described as a taxable person.[42] This terminology avoids the confusion caused in some states by calling such persons "taxpayers." The confusion arises because the taxpayer, in the sense of the person bearing the economic incidence of the tax, is the person receiving a taxable supply. This also applies for calculating the direct tax on a supply. For example, in the case of a supply of property rights on which a royalty is paid, the person supplying the rights is the taxable person for VAT purposes (while the person paying the royalty to the taxable person is in the economic sense the taxpayer), and the taxable person is in both law and practice the taxpayer of any income tax in respect of the receipt of the royalty.

A VAT law should include all legal persons created under the law of the state (or of a foreign country) that engage in economic activities of any kind, as well as all physical persons. The text should be drafted to bring all legal and physical persons potentially within the category of "taxable persons." It may usefully refer to the precise laws of the state under which such persons or entities derive their juridical status.

One problem arising here is whether the law should include partnerships and associations as taxable persons. The extent to which associations and partnerships have juridical personality separate from the individuals who are their members varies from one state to another, and the law may need to reflect this. In some legal systems, they do not have separate juridical personality.[43] A

[42]This is the term used in the English-language version of the EC Sixth VAT Directive, *supra* note 3, art. 4. It is also used in the Irish Value-Added Tax Acts, IRL VAT § 8; the Basic World Tax Code, Hussey & Lubick, *supra* note 13, § 213(b); and the Singapore Goods and Services Tax, SGP GST § 8(2). The French term is *un assujetti*, although the term *redevable* is also used. *See* FRA CGI art. 256; CHE OTVA art. 4; *see also supra* ch. 4, note 17. The English term used in Ministry of Finance, *supra* note 4, is "taxpayer." Venezuela is an example of a state with a general tax law (the Organic Tax Code) that lays down general rules about "taxpayers." VEN COT arts. 22–24. It also makes provision for "persons responsible," namely, those who are not taxpayers but who have responsibilities to collect or pay tax under tax legislation. *Id.* arts. 25–29. Because of this, the Venezuelan Wholesale and Luxury Tax, as the local equivalent of a VAT is called, applies to "taxpayers" as defined in the Organic Tax Code and "persons responsible." VEN IC art. 1; VEN COT arts. 22, 25–28. This leaves the precise personal scope of the VEN IC to be defined by the general tax code. The New Zealand law uses the term "registered person," but makes it clear that a person is to be treated as a registered person if the person is not registered in cases where the person should be registered. NZL GST § 2(1)(defining "registered person" as "a person who is registered or is liable to be registered under this Act"); *see also* GBR VAT § 3(1)("A person is a taxable person for the purposes of this Act while he is, or is required to be, registered under this Act"). Both the United Kingdom and New Zealand have high taxpayer compliance. The term used in this chapter does not assume compliance.

[43]For example, in Germany, Latvia, and many common law states. In civil law states, joint ventures may not have separate legal personality. The United Kingdom has an even more complex situation whereby partnerships have legal personality in part of the state (Scotland) but not in the whole state. *See also* ch. 3, sec. V(D); vol. 2, ch. 21.

VAT law may regard an association or partnership as a taxable person separate from the individuals in the association or partnership, although the association does not, for general legal purposes, have separate personality. This is consistent with an intention of excluding from the scope of the tax individuals engaged only in noncommercial activities.

If separate registration of a partnership is provided for, a mechanism should be introduced to give effect to the recognition. This will treat the partnership as making or receiving all relevant supplies and will ignore those supplies as being made by the partners (even though, for other legal purposes, the reverse is the actual legal position).[44]

Some states also allow or require[45] separate branches of a juridical person to be regarded as separate taxable persons (in which case a supply by one branch to another branch is a taxable supply) or allow groups of companies (e.g., a parent company and its subsidiaries) to register together as one taxable person (in which case a supply by one of the companies to another will not be a taxable supply). Where separate branches are treated as separate taxable persons, or groups of companies are treated as one taxable person, some administrative machinery is necessary to recognize the branches and groups.[46]

A VAT law does not usually need to expressly mention foreign legal persons, that is, persons that derive their legal personality from the law of some other state, as with a company registered in a foreign state. However, it is intended that all legal persons be registered for VAT if they conduct within the state activities of the kind and level defined in the law. In practical terms, this means that some branches or permanent establishments are required to apply to be registered, while others are found, following the jurisdictional rules of the state, not to be making supplies of the required level within the state. This problem has some similarities to that of deciding whether a person is a resident for income tax purposes. In most states, for example, a foreign company becomes "resident" and, therefore, within the jurisdiction of the state if it establishes a branch, agency, or permanent establishment within the state. There is an agreed definition of "permanent establishment" in article 5 of the OECD

[44]For a clear example of this kind of provision, *see* NZL GST § 57.

[45]For example, Kazakstan did so before July 1, 1995.

[46]The corporate income tax legislation of many states recognizes the joint treatment of a group of companies for income tax purposes. These laws provide, for example, a definition of the link creating a group (perhaps a 50 percent or 75 percent shareholding by the parent in the subsidiary). They often reflect the accounting convention of the integration of the activities of subsidiary companies into the accounts of the parent. They might be used by analogy for the VAT. Few states, however, recognize registration for separate divisions for direct tax purposes. Separate registration may prove advantageous for VAT purposes by allowing, for example, a split between the taxable activities of a company and nontaxable activities where those separate groups of activities are carried out by different divisions of a company or organization. It will also allow a trading division within a public body to register, while the main body remains unregistered.

Model Tax Convention.[47] A similar approach could be adopted for the VAT.[48]

Governmental bodies at the national, regional, and local levels are to be included as taxable persons, in the same way as any other person, if they engage in economic activity. It is appropriate to except from this full rule "the central lawmaking and executive authority of the state," as no useful purpose is served in normal situations by such an inclusion. These institutions rarely engage in business activities. By definition, the main activities of the state legislature and the state's central governmental agencies are sovereign activities of the state and not commercial activities. This is also true of the activities of the judiciary in the state courts. It may be felt appropriate to provide a definition clarifying which of these bodies are expressly excluded from the scope of the VAT. The precise terms used need to be adapted to make sense in the context of the organization of government of the particular state.[49]

B. Excluding Persons with Low Levels of Business Activity

Most states require only some of the many persons active in business within the state to be taxable persons.[50] This is normally achieved by setting

[47]OECD Model Tax Convention, *supra* note 40, art. 5.

[48]The key test for registration is normally whether a taxable person makes supplies of the required level within the state. For that purpose, it does not matter in what form the supplier is present in the state—although in practice it may prove difficult to identify the person who ought to register by reason of a single transaction. Residence is, however, relevant to some supplies of services and for certain procedural purposes (e.g., nonresidents being required to appoint a resident tax representative). One approach that accepts this problem is that of the United Kingdom in providing that "a supply of services shall be treated as made . . . in the United Kingdom if the supplier belongs in the United Kingdom. . . ." GBR VAT § 7(10). A supplier of services is treated as "belonging," if there is a business establishment in the country. *Id.* § 9(2). Either a branch or an agency is treated as a business establishment. *Id.* § 9(5)(a). "Branch or agency" is the phrase used in U.K. income tax law instead of "permanent establishment." GBR ICTA § 11. The phrase used in the underlying EU law is "fixed establishment." EC Sixth VAT Directive, *supra* note 3, art. 9. The French term for this is *établissement stable*. FRA CGI art. 259. This is the same term as that used in the French version of the OECD Model Double Tax Convention for "permanent establishment." OECD Model Tax Convention, *supra* note 40, art. 5. It is used directly in the French law, CGI art. 259, and the French version of the Swiss law, OTVA art. 9. It must also be noted that the concept of permanent establishment is not without its own problems. For example, if a business has a permanent establishment within the jurisdiction, is that establishment deemed to supply all supplies made to the jurisdiction by the company, even though they are not made through the permanent establishment? It may be so treated under the "force of attraction" principle, *cf.*, KAZ TC art. 5, which is, however, rejected by many treaties for income tax purposes.

[49]For the position relating to the diplomatic and consular functions of the state, *see infra* sec. IV(K).

[50]Some states, however, require all legal persons to be registered and have a minimum limit for individuals only. States may also exclude certain kinds of activity (e.g., excluding retailers but taxing wholesalers). This is usually considered problematic and contrary to the spirit of the VAT.

a minimum level or threshold of business activity and requiring only those persons with levels of activity above the minimum to be taxable persons. Those with levels of activity below that level are not required to be taxable persons, although they are often given the right to voluntarily choose to be taxable persons. The usual measure of business activity is the total turnover of taxable goods and services supplied by the person over a set period.[51]

The total to be taken into account for the threshold is the *total taxable supplies* of that person. This means the total of all supplies made by that person that are treated as taxable supplies within the definition of the law. The total does not include supplies exempted from VAT or outside the scope of VAT. This means that a person conducting a business that is largely exempt is outside the scope of the registration provisions if the taxable activities reach a total less than the threshold, although the total economic activity of the business is high.

The precise level of threshold varies widely from one state to another and, within a state, varies from one time to another. There are several reasons for this. Limits vary partly as a reflection of the economic structure of a state. Some states have a comparatively greater number of marginal small businesses involving one person or one family than other states. Even taking account of the differences, in many states self-employed individuals or single families engaged, for example, in subsistence farming or small market trading will contribute little to the collection of VAT. It is also administratively difficult—and therefore expensive—to collect tax from such people. In addition, the exclusion of smaller traders from VAT through the use of a threshold limit is particularly useful at the introduction of the tax, when there are limits on available administrative resources and taxpayer knowledge of the tax is at a minimum.

The law may be drafted to allow the authorities to alter the amount set from time to time, both to ensure that the tax is working properly and, in any event, to ensure that inflation does not have too significant an effect on the practical level of the threshold.[52]

[51]The threshold will need to be defined with some care. There are two bases for definition: actual turnover of taxable supplies over a defined period and estimated turnover over a defined period. The test may be based on past periods (when actual turnover can be used), future periods (when estimates must be used), or a period such as the current calendar year, which is both past and future. An estimate might be based on the amount that it is reasonable to assume or, alternatively, likely that the business will exceed. The advantage of including estimates is that this allows registration to be made mandatory before the threshold is reached. This makes for easier enforcement. However, there will be situations where the estimate proves to be too high, and registration is forced in a case where it was not objectively required. In such a case, if other provisions force a registration to remain for a set period, the result may be seen to be unfair.

[52]This provision is extremely sensitive in economies with high inflation. In some states that have severe problems with inflation, but that may not have a well-developed index of consumer prices, the practice has been adopted of linking the threshold not to a set sum of money but to an indexed factor, such as the minimum monthly or annual wage. The threshold then adjusts automatically with that factor.

This discussion assumes that a law has only one registration limit. Some states have more than one limit, for example, a lower limit by reference to the supplies of services or of certain kinds of services, and another, higher limit for the supply of goods.[53] This allows the state authorities to impose limits that reflect the different proportions of value added involved in providing goods and providing services, although it can do so only by adding another level of complexity. A provision setting more than one threshold will also need to provide a definition of the kinds of supply that count toward the lower level rather than the higher level and to provide for those who make both kinds of supply.

It should be emphasized that the threshold limit applies to all supplies made by one person or by that person's agent for the person. It is possible for a person who is potentially a taxable person to avoid that result by transferring some of the person's activities to another person (who might be under common ownership with the person transferring). States concerned by such practices may adopt provisions requiring that the total of activities in such situations be added together and be deemed to be the activities of one taxpayer.[54]

It must also be clear that, apart from aggregation rules, the threshold applies separately to each taxable person. For example, if *A* and *B*, both being active in business independently, also form a partnership, then the threshold applies separately to the taxable turnover of *A*, of *B*, and of the partnership.

C. A VAT Register

To administer the VAT, it is standard practice to establish a formal state register of those who are registered persons. There must then be a requirement that any person who is, or should be, a taxable person take the necessary action to seek to be registered for the VAT. The law or regulations need to confirm the register and give it official status. Penalties will also be needed to ensure that all those required to do so apply to be registered. Recognizing this requirement, laws sometimes refer to taxable persons as "registered persons" or "persons required to register."[55]

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[53]This happens in Ireland, where the higher limit applies to traders with at least 90 percent of their taxable turnover deriving from the sale of goods, with the lower threshold (about half the level of the higher threshold) applying to all other taxable persons. IRL VAT § 8(3)(c), (e).

[54]An example of this kind of antiavoidance provision is found in the United Kingdom. GBR VAT sched. 1. This was strengthened considerably by the U.K. Finance Act 1996, sched. 3. The tax authorities can treat a series of separate companies as carrying on one trade so as to require them or one of them to register on behalf of the "group." The Japanese law has a "substantial attribution" rule based on similar rules for the direct taxes under which those who substantially enjoy consideration for transfers are regarded as the entities making the transfers. *See* JPN CTL art. 13; Ministry of Finance, *supra* note 4, at 159. A taxable person manipulating levels of transfer will be within the scope of this provision.

[55]*See supra* note 42.

D. VAT Numbers

States sometimes decide to adopt and adapt an existing register, such as the register for companies or a general register of taxpayers, to act as the VAT register. That is for a state to decide, but the register must be capable of generating a unique VAT number for each taxable person,[56] as well as providing the tax authorities with an up-to-date list of those, and only those, who are taxable persons. For reasons of good administration, states with more limited administrative resources find it increasingly attractive that the VAT number be the same as the taxpayer identification number used for income and other taxes. The practice must meet the need to provide all those registered for VAT, whether or not they are income tax payers, with a unique number at the time they are registered for VAT.

The VAT number is used by the tax authorities and by taxable persons themselves to ensure the proper operation of an invoice-based VAT. Every invoice is important to the tax authorities wishing to collect the VAT recorded on it and also to any taxable person paying the VAT recorded on the invoice to ensure deduction of the input tax on the invoice. For this reason, it is necessary to be able to identify the taxable person charging the VAT on the invoice. The law should provide that a taxable person is under a duty to put his, her, or its VAT number on the invoice, so that this can be achieved.

Once a taxable person has been issued a VAT registration number or has had the registration confirmed under a given number, the law should require the person to use that number on all official communications. For example, the number should be indicated on all communications with the tax authorities and perhaps other documents, such as official orders or official stationery.

E. Voluntary Registration

States often allow those who are not required to be registered (because their activities are below the level of the threshold) to register voluntarily. This may be appropriate for many organizations that intend to have a large turnover, but have not yet reached it; incur large expenditure in one year, expecting the income in the next year; or are carrying out business activities at a level that does not reach the registration limit, but that do not wish this information to be known by customers (e.g., younger self-employed providers of services). Voluntary registration also allows those operating just below the

[56]The precise nature of the number used, and its status as a unique registration number for VAT purposes, is particularly important where the registration number is used in international transactions. Best practice will require both that the number identify the taxable person by reference to the state issuing the number and that the number contain a check digit so that routine checks can be made against mistakes and deliberate wrong use of numbers. International identification is provided within the EU by a standard international prefix. The check digit requires that the number be issued or monitored using standard mathematical methods.

threshold level to avoid any competitive disadvantage compared with other operators who are required to be registered.

There is sometimes a danger to the integrity of a tax system in allowing uncontrolled voluntary registration. First, this may allow those who are not in reality engaged in business to register with a view to claiming rebates of input tax when they have no real intention of paying much output tax.[57] Such persons should not be entitled to register unless they are genuinely involved in business, but both practical and legal safeguards are needed to ensure that the tax authorities can control this situation. Failure to control it may result in significant revenue loss. It may be deterred to some extent by placing a minimum period on voluntary registration, as noted below.

A second reason for limiting voluntary registration is that the right to register voluntarily may have the effect of making many more persons "taxable persons" than is administratively appropriate for the state, particularly when a VAT is first introduced and the state has chosen to set a high threshold level.

Provided that the tax authorities can ensure that the integrity of the VAT is safeguarded, economic neutrality will be achieved only if voluntary registration is allowed. A compromise adopted by some states introducing a VAT is to set a minimum activity level for compulsory registration and a lower minimum level for voluntary registration. Where these rules operate, a person can register voluntarily only if the lower minimum is met. This excludes those persons with no real economic activity or whose businesses have not yet started. At the same time, it allows some voluntary registration to control distortions between those just above and those just below the compulsory threshold.

F. Exporters and Persons Engaged in International Activities

Most states provide that there is no VAT on exports.[58] To avoid exporters paying VAT, provision is made for them to claim back any input tax they have paid in making the exports (see below). Therefore, exporters and those in a similar position must be brought onto the register. If they are not on the register, they will not be entitled to claim rebates of input tax, and their activities will be affected. An exporter may not have a level of activity great enough to be above the minimum level requiring registration. Any provision in the law having the effect of excluding voluntary registration must therefore be accompanied by another provision ensuring that exporters are allowed to register regardless of their level of activity.

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[57]Some of the states adopting a VAT in recent years have experienced problems with this kind of fraud.

[58]This follows from adoption of the destination basis of taxation. *See supra* sec. I(D).

G. Effect of Nonregistration

A person who is required to register for the VAT is a "taxable person" who is subject to the duty to impose and collect VAT on all supplies whether or not the person is registered. It is important that the law make this clear and not exclude a person from the scope of the law just because of a failure (deliberate or otherwise) on the part of the person to apply for registration. It will also be appropriate to impose penalties on those who should have applied for registration but have failed to do so, as well as to ensure that full powers exist to collect VAT from those persons in respect of all supplies that have taken place (or are assumed or estimated to have taken place) when the person was not registered but should have been registered.[59] However, such a person is not entitled to issue VAT invoices. Hence, the person's customers cannot claim input tax credits in respect of supplies from such a person.

The converse to this position should also be made clear in the law. A person who is not registered for VAT and is not required to be registered is outside the scope of the law. A person outside the scope of the law has no right to claim a rebate for any input tax paid. The person also has no right to impose VAT, or anything purporting to be VAT, on supplies made by the person. To ensure that persons do not abuse this position, two safeguards may be put in place. First, a person who collects or tries to collect VAT while not empowered to do so is made liable to criminal penalties. Second, the VAT law provides powers to collect the sums of money from such a person although the sums are strictly not VAT.[60] A variant on the second provision is to ensure that the overpaid VAT is repaid to the person overpaying.

H. Cancellation of Registration

The law should provide for three situations where VAT registration should be canceled.

The first case is where a person has been registered for VAT properly, but where the registration is no longer appropriate. This will occur where a person was required to register because the person's business activities exceeded the threshold but where, subsequently, the person's level of business activities has declined to below the threshold. If the person is continuing in business, then, if the person so wishes, a voluntary registration may be maintained. However, the person should have the right to deregister. Mechanisms are needed to allow a person to remove the person's name from the register when this occurs.

The second case is where the person has ceased to carry on business activities (or has ceased to qualify for some reason for voluntary registration). If

[59]The amount collected is typically reduced by input tax credits supported by invoices.

[60]The New Zealand law provides the Commissioner of Taxes with the power to collect the tax in these circumstances by an assessment if "[a]ny person, not being a registered person, supplies goods and services and represents that tax is charged on that supply. . . ." NZL GST § 27(1).

so, the person's name should be removed from the register whether or not the person applies for deregistration. Subject to safeguards for the integrity of the VAT collection process, deregistration should take place when the person ceases to be entitled to register or no longer wishes to be registered.

The third case is where the person has been registered by mistake or by misrepresentation on the part of the person. In these cases, it will usually be appropriate to provide that the person is removed from the register retrospectively to the moment of registration. In other words, the registering authorities can take action so that the person registered wrongly can be treated as if the registration had never occurred.

The charging provisions of the law should deal with VAT liability that arises by reason of a person ceasing to be registered. In addition, the powers of the tax authorities should remain in place notwithstanding the deregistration to deal with such charges.

Safeguards are needed to deal with those who have been registered, but should not have been registered, and for those who appear to be registering properly, but who use registration to obtain large refunds of input tax without later paying in any corresponding output tax. In part, these safeguards may be linked to the granting of refunds for input tax.[61] Some states add further safeguards, for example, preventing a person who has registered voluntarily from deregistering within a set time (perhaps one or two years) of first registering.[62]

I. Continuing a Registration Despite a Change in the Taxable Person

Situations will arise where a person ceases carrying on a business unavoidably. For example, the death, incapacity, or insolvency of an individual or the winding up of a company may mean that the person registered as running a business is no longer running it. The business will usually continue at least for a time to be run by some other person. For example, the trustee in bankruptcy or a receiver for a debtor may run the business in the owner's place, and the personal representatives of a deceased person will often run the business until it can be transferred to some other person. In these cases, states often make provision to treat the registration as continuing notwithstanding the change in identity of the taxable person. Rules might deal similarly with changes in membership of a partnership where the partnership continues to run the business without a break. These provisions should be linked with other provisions preventing a transfer of title in cases of continuing registration from constituting a supply. The rules can be more liberal than the reorganization provisions of the income tax.[63]

[61] *See infra* sec. VII(L).

[62] For example, the limit in Japan is two years. JPN CTL art. 9.

[63] If a reorganization were to be considered a taxable supply, the successor entity would obtain an input tax credit in the same amount. The logic of VAT does not require tax to be imposed in such a situation, as long as the successor continues to be a taxable person. *See also infra* sec. VII(E).

III. Supplies of Goods and Services

A. Transactions Within the Scope of the Law

A broad-based VAT is designed to bring within its charge every kind of economic transaction, subject to limited exceptions. This is normally achieved by drafting a very broad provision imposing VAT on an extremely wide range of business transactions and then removing by specific exception any transaction that is not to be liable.

Transactions are usually stated to be within the scope of VAT if they are "supplies of goods or services." These terms are given extremely wide meanings that go significantly beyond the usual meanings of "supplies," "goods," and "services" in most languages. The aim is to bring within the charge all economic activity. In particular, the terms need to cover transactions dealing with land or other immovable property and with intellectual property rights. Therefore, the terms should not be limited to the meanings of those terms, for example, in consumer law.

For reasons of linguistic simplicity, all the relevant transactions are termed "supplies" in most English VAT texts. However, there is no one concept of "supply" in many languages.[64] A more formal presentation of the scope of a VAT law might refer to (1) transactions involving the transfer of the legal rights to goods, and (2) other transactions within the scope of VAT but not involving such a transfer.

In actual drafting, one can employ less clumsy expressions than this, as long as the underlying intent is not lost. The discussion will deal with the formal classification.

Besides identifying what transactions are within the scope of the VAT, rules are required to determine where transactions occur, when they occur, and who for the purposes of VAT is carrying out, or treated as carrying out, the transactions.

B. Supplies of Goods

VAT laws usually contain a definition of a "supply of goods" or "goods." It is felt, in the light of the formal presentation above, that the better practice is to offer a definition of a "supply of goods." Again, the definition needs to avoid being too closely related to any definition of a similar concept in the commercial or consumer law of the state. This is because the scope of the VAT rule will usually be wider than the scope of the commercial law. Other rules, such as timing, may also be different. Nonetheless, those defining a "supply of goods" in the VAT context might well gain from reviewing the other definitions within the state of those terms.

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[64] *See supra* sec. I(B).

A possible definition[65] of a "supply of goods" is a transfer of the right to dispose of tangible movable property or of immovable property other than land.[66] The consequence of this form of definition, coupled with a broad definition of services (see sec. D below), is that the transfer of intangible property will be considered a service.

The problem with a general definition of this concept is that there are fundamental differences in approach to the sales of goods in different legal systems, including differences within the European Union between common law states and civil law states. The definition offered here is a compromise between the common law and civil law approaches to property. The definition in a state may need to be aligned more closely with the property laws of that state.

For example, the common law approach identifies property as tangible (items that can be held or touched—usually referred to as goods or products in commercial laws) and intangible (property that cannot be touched, such as legal rights). It also distinguishes between "personal property" (including tangible property that can be owned by individual persons, such as goods) and "real property" (this includes only legal rights of ownership to land and things attached to or inseparable from land). In countries with a civil law tradition, a distinction is drawn between movable property and immovable property on a differing basis (e.g., a building can be treated as separate from the land on which the building stands, and the categories of immovable property may be related more to the physical ability to move the property than to the underlying legal rights). VAT laws may not precisely follow either of these approaches. The objective of the VAT rule is to impose tax on the economic substance of what is occurring (and for which a person receives payment) rather than on its precise legal form.

[65]The EC Sixth VAT Directive defines "supply of goods" as "the transfer of the right to dispose of tangible property as owner." EC Sixth VAT Directive, *supra* note 3, art. 5. This is an English rendering of the French "le transfert du pouvoir de disposer d'un bien meuble corporel comme un propriétaire," FRA CGI art. 256, and does not fully convey the civil code technicalities of the French version. The Swiss-French version is "le pouvoir de disposer économiquement d'un bien en son propre nom." CHE OTVA art. 5. The U.K. law does not define "supply" (beyond saying that it includes all forms of supply, GBR VAT § 5(2)(a), a formula also adopted by the New Zealand law, NZL GST § 5(1)), or "goods" (defined in New Zealand, NZL GST § 2(1)) or "supply of goods." The Basic World Tax Code defines supply as "the act of providing a good or service. . . ." Hussey & Lubick, *supra* note 13, § 212(c).

[66]Some definitions also expressly exclude "money" from the definition. For example, the New Zealand definition states that "goods" includes "all kinds of personal or real property; but does not include choses in action or money." NZL GST § 2(1). (Chose in action means a right to bring a lawsuit or to recover a sum of money.) This is the widest definition possible in the context of the present form of law. Other forms of property such as intellectual property are therefore not goods. This is, however, an approach made within the context of the common law. Other systems of law do not draw the same distinctions between tangible and intangible property. For example, under the Japanese consumption tax law, the leasing of assets (goods) is treated in the same way as sales of assets and separately from the provision of services, and leasing is defined to include transfers of intangible property in assets. *See* Ministry of Finance, *supra* note 4, at 145.

A "supply of goods" is not constituted merely by a transfer of possession, which is a transfer of the use of goods, not of the goods themselves. A transfer of the use of goods is a supply of services. What constitutes the right to dispose of property depends on the laws of each state. The definition set out above avoids reference to a sale of the goods or the rights of ownership. The intention is to avoid complexities of the commercial laws of a state, such as reservations of title, that may prevent ownership from transferring but that do not prevent all the physical attributes and economic value of ownership from being transferred. Equally, a transaction that has all the attributes of a sale but later turns out to be avoidable for legal reasons does not thereby cease to be a supply, although there may later be a supply back again if the goods are transferred back.

If a transfer of possession (a supply of a service) is followed by a transfer of the title, or rights of ownership, the supply of goods is the supply of those rights and reflects the residual value after taking into account the value of the services already supplied.

No separate definition of "goods" is needed save the explanation in the above definition or its equivalent.[67] The intention is to include in the category of "goods" all those forms of tangible property that are to be within the scope of the tax. Land is often excluded from the definition of goods deliberately for reasons discussed below. Sometimes money is also excluded. This will depend in part on how money is viewed in the property laws of a state (particularly, whether money is regarded as tangible or intangible). In reality, whether or not money is excluded here, all forms of VAT exclude a charge to VAT on transfers of money (or, properly, the use of money) by exemption. Any exclusion of property or transactions from the definition of "supply of goods" will bring it within the definition of "supply of services" set out below, thereby requiring the exclusion to be set forth again.

Many laws also extend the definition of supplies of goods to cover supplies of energy and other kinds of supply that are similar to goods. For example, a supply of electricity is not generally treated under civil or commercial law as a supply of goods, nor is a supply of heat, refrigeration, or air conditioning. However, it is usually regarded as convenient to treat them as supplies of goods to apply the timing and location rules that relate to goods.[68]

C. Land

The reference to "immovable property other than land" is designed to take account of the fact that some states have wider definitions of immov-

[67]For alternative approaches, *see supra* notes 65 and 66; *see also* Hussey & Lubick, *supra* note 13, § 212(a), (c) (defining "goods" as well as "supply"). For a lengthy definition of "supply," *see* NZL GST § 5.

[68]The EC Sixth VAT Directive requires that "[e]lectric current, gas, heat, refrigeration, and the like shall be considered tangible property." EC Sixth VAT Directive, *supra* note 3, art. 5(2).

able property than other states. Whatever the scope of the definitions within a state, a sale of land should be excluded from the scope of a supply of goods.[69] "Land" in this context means the rights of a person as the owner to legal title and exclusive possession and control over any part of the surface or subsoil of the territory of the state. The emphasis is on the legal title, not on the actual soil. This may or may not automatically include legal title and possession of any buildings, structures, or equipment fixed to the surface or in the subsoil.[70]

The reference to legal title is based on the assumption that the law of the state provides for the sale of the whole legal interest in land. In a number of states, only limited sales of interests in land can occur and to that extent the comments are not relevant. Another point of difference in the laws dealing with land or immovable property of states is that some states have laws under which a building on land is legally regarded as part of the land, and so cannot be sold separately from that land.[71] In other states, a building can be sold even where the land is not sold or cannot be sold.[72] The suggested definition will have different effects in these different situations. Consideration will need to be given to the adaptation of the law to the situation applying in the state.

Exclusion of land from the definition of goods is for reasons of both principle and practical administration. Some of the arguments from principle are reviewed in the chapter by Cnossen[73] and are not rehearsed here. A practical problem is how best to tax works or buildings on land without also taxing the land. There are several possible solutions to the problem of taxing development (including buildings) and not land. The methods used in OECD states are also reviewed by Cnossen.[74]

If a law adopts the definition set out above, a sale of undeveloped land is never subject to VAT. A sale of land by a private person would not, in any event, be within the scope of the tax, because the sale would not be part of a

[69]Compare the New Zealand definition set forth in note 66, *supra*, as one attempt to widen the scope of the tax to cover certain land transactions. For the policy behind the statement, *see* Tait, *supra* note 2, at 61–66, 80–90; *see also* ch. 7 *infra*. It may be noted that the New Zealand law contains a number of exemptions removing certain transactions involving land from the scope of the tax. It was found necessary on more than one occasion after the passage of the act to widen those exemptions, despite the clear policy in New Zealand against such exclusions.

[70]In the preliminary edition of the Basic World Tax Code, Hussey and Lubick catered to this by separately excluding land and "existing buildings" from the definition of "goods." Ward M. Hussey & Donald C. Lubick, Basic World Tax Code and Commentary § 212(b)(2), (3) (1992). Section 212 of the 1996 edition now includes land and buildings. For an explanation of the change of view of the authors, *see* Hussey & Lubick, *supra* note 13, at 289.

[71]This applies in states that have adopted English land law.

[72]This applies in many civil law states. It also applies in states, such as those of the former Soviet Union, where land cannot be sold, but a building on the land can be sold.

[73]*See infra* ch. 7.

[74]*See id.*

business activity, and, in many cases, the seller would not be a taxable person. The transfer of an interest in land is not excluded from the scope of VAT by this definition. This is because the transfer of an interest in the land (i.e., a transfer of part of the total ownership of the land) is not the same as a transfer of the land. Instead, most kinds of transfers of interests, such as leases or rights to use land, are exempted under the VAT laws of many states. Short-term leases are subject to VAT. Works done on land, for example, civil engineering work or building work for the owner of land, are not excluded from the scope of VAT by this definition. Therefore, such works are usually subject to VAT.

The result of these definitions can be inconsistency between the VAT treatment of different transactions relating to land. Therefore, the VAT treatment of land needs careful consideration within the context of the landholding laws and practices of the state, with particular regard being given to the position of buildings sold by and to taxable persons for use in a business. For example, many states charge tax on a new industrial or commercial building, although not all those states charge tax on the sale of a building completed before the start of the tax in the state.[75]

D. Supplies of Services

A "supply of services" is often defined as any supply within the scope of VAT that is not a supply of goods or a supply of land.[76] This definition, when read with the definition of "supply of goods" means that *any* supply is within the scope of the charge to VAT. If that is so, it may be asked why there is any need to distinguish between "goods" and "services." The answer is that the rules locating a supply of services are different from those for a supply of goods, as are the rules determining when such supplies occur. Further, where VAT is charged at more than one rate, the precise identity of the supply may be critical. Also, the self-supply rules explained below apply to goods but not to services. Finally, a supply of goods across the frontier of a state is an import or export of those goods and is subject to the customs regime of the state. This does not apply to supplies of services. The latter point serves to emphasize that, in cases of doubt, it may be useful to consider the scope of the customs law of the state in considering whether or not something is a "good."

[75]*See id.* for a further discussion.

[76]"Est considérée comme prestation de services toute prestation qui ne constitue pas la livraison d'un bien." CHE OTVA art. 6(1). In the European Union, "supply of services shall mean any transaction which does not constitute a supply of goods." EC Sixth VAT Directive, *supra* note 3, art. 6(1). Where goods are defined as excluding money, it is appropriate to provide that "services means anything which is not goods or money." *See* NZL GST § 2(1). The Japanese law has no equivalent and relies instead on a comprehensive list of kinds of service.

It is therefore not possible[77] to have a supply that is not either a supply of goods or a supply of services, except for supplies of land or money. From this, it is clear that "services" has an extended meaning. It covers the use of all forms of property and also transfers of the right to dispose of intangible property. It also covers negative events, such as refraining from activity or undertaking by covenant or agreement not to do something.[78] Indeed, "services" are supplied whenever value is added because of a transaction that falls within the scope of VAT. A transaction will fall within the scope of VAT under the normal rules if the transaction is a business transaction, if the person making the supply is a taxable person, and if some other person makes a payment for the supply.

VAT laws rarely offer a useful separate definition of "supply."[79] A supply will occur whenever there is some transaction or event involving a taxable person whereby the taxable person receives payment (or consideration) for the effects of that transaction or event. In other words, the concept of value added is reflected by this broad definition. Any narrower definition, and any attempt to place limits on the meaning of "supply" or of "services," would exclude economic activities from the scope of VAT.

Interpretation and application of this provision should reflect this broad policy approach because it ensures not only efficiency in collecting the tax but also fairness between one taxable person and another. It is only if all economic activities that add similar value are taxed similarly that a fair and easily administrable tax can exist.

Comment has already been made about the exclusion of land and money from the definition of supply of goods. If the above definitional structure for supply of services is used, it is necessary to repeat those exclusions in the definition of supply of services.

E. Supplies by Employees and Officeholders

The law should provide that the service undertaken by an employee for the employer of that employee does not form a supply made by that employee. Two ways of doing this are to expressly say so or to ensure that an employee

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[77]Save by express provision. For example, the U.K. law provides that the transfer of an ongoing business is a supply, but of neither goods nor services. Special Provisions Order 1995, No. 1268, art. 5(1) (GBR), *reprinted in* Butterworths VAT Handbook 1995, at 451. This is a drafting device to remove that kind of transaction from the scope of VAT, but it does so in a way that defies the logic of the legislation of which it is part.

[78]For example, the EC Sixth VAT Directive includes in the definition of supplies of services "obligations to refrain from an act or to tolerate an act or situation." EC Sixth VAT Directive, *supra* note 3, art. 6(1).

[79]*See supra* the definitions quoted at notes 65 and 76. Some laws, such as the French, provide a series of examples of what is included in delivery and provision, FRA CGI arts. 256–59C; others refer to "transaction" instead. *See, e.g.*, BGR VAT art. 1.

can never be a taxable person, by providing that a person is a taxable person in respect only of supplies made by that person *independently*.[80] The rule also covers all those holding office, such as company directors and all government officers and employees.[81]

F. Supplies by Agents

Where a supplier supplies goods or services through an agent to another person, the supply is made not by the agent but by the supplier. Whether in a particular case an intermediary is an agent will depend on the precise legal nature of the contract between the persons involved. For example, an employee is the employer's agent. The employee's service, if supplied directly or indirectly to a third person, is a supply by the employer. This rule covers all supplies from employees, including the case where an employee works directly for some third person, if the third person contracts with, and pays, the employer. If the employee is seconded to the third person and is paid directly by that third person, then the true relationship may be that the employee is now employed by the third person. If the third person makes no payment to the employer, then the payment to the employee will probably not constitute consideration between the employer and the third person, so that there is nothing on which VAT is to be paid.

An agent is normally entitled to a fee or commission for services rendered to a supplier, and VAT is charged on those services (unless they are exempt). Where an agent is used, it is therefore for the supplier, not the agent, to charge VAT and to pay it to the budget. Special powers may be considered necessary to enforce payment of VAT by an agent where the agent, rather than the supplier, has the money to make payment and the supplier has not paid.

One special case is that of a sale by auction, or other forms of sale where the agent does not reveal that there is an agency or declines to reveal the identity of the person for whom the agent is acting. Here, the supplier effectively remains unidentified. Therefore, it may not even be clear whether the supplier is or is not a taxable person. In such cases, it is necessary to treat the agent as a principal for the purposes of charging VAT to customers and to include rules requiring that this be the case, whatever the underlying legal relationships. The effect of this is to require the agent (if a taxable person) to issue invoices to the customer and for the principal (if a taxable person) to issue invoices to the agent for the items sold.

[80]See the definition of taxable person in EC Sixth VAT Directive, *supra* note 3, art. 4(1), on which this text is based. The reference is to "independent workers" rather than to "dependent workers."

[81]*See also* the discussion on employment status in connection with social security, *infra* ch. 11, and income tax, vol. 2, ch. 14.

G. Mixed Supplies and Multiple Supplies

In practice, it is often difficult to identify the nature of a supply. Often what is supplied is a mixture of different things and often of both goods and services. For example, *A* agrees to sell some goods to *B* and also to deliver them to *B*. *A* also agrees to install them upon delivery. An engineer agrees to repair *B*'s broken machine and supplies some small spare parts while doing so. A club allows *B* to become a member and provides *B* with both goods (such as books and a special badge) and services (such as advice or the use of club premises) when *B* joins. In each of these cases, is there a single supply or more than one supply? Are the supplies of goods or of services?

States need to adopt simple practical rules for dealing with these everyday occurrences so that those making mixed supplies and multiple supplies can determine without excess difficulty how and when VAT is to be applied to each supply. One broad practical rule is to treat any supplies incidental to a main supply as part of that main supply. If, for example, *A* makes no separate charge for delivery, then the service of delivery is ignored, and the supply is taxed only as a supply of goods. If the engineer charges separately for the spare parts, then VAT should be applied separately to them. A multiple supply, such as club membership, may require that the one payment be apportioned between the different elements of club membership.

A simple broad VAT allows many of these problems to be avoided. If none of the forms of supply is exempt and all are subject to VAT at the same rate, then it is not as critical to separate the elements of a supply. When numerous categories of exemption are allowed and more than one rate of VAT is introduced, administration becomes more complicated because much closer attention must be given to this problem.

H. When a Supply of Goods Takes Place

The time of supply is important for deciding when a tax invoice has to be issued in respect of a supply, when tax is due in respect of a supply, the rate at which the tax is payable,[82] and in which taxable period a return has to be made in respect of that supply and in which any tax credit can be claimed by the person receiving the supply.

The rules determining when a supply of goods takes place vary from one state to another[83] but generally a supply of goods takes place when

- a VAT invoice is issued for the supply,
- the goods are delivered,

[82]In cases where the rate of tax has been changed from one period to the other.

[83]This applies for invoice-based and transaction-based approaches to VAT. If the VAT is levied on an accounts base (e.g., in Japan), the timing rules are the same or similar to those applying for corporation tax. *See* Ministry of Finance, *supra* note 4, at 172–74. This is often based on general accounting principles and therefore relates either to the cash transaction or to accrual.

- the goods are made available,
- the goods are removed or transported to or for the customer, or
- the goods are paid for in whole or in part.

In accounting terms, these rules include both a cash basis and an accrual basis for timing a transaction. In the interests of securing the cash-flow position of the state and of ensuring efficient collection of the VAT, it is usual to provide that the time of supply occurs when the first of these events occurs, or soon thereafter.[84]

Once a VAT system is established, it may be most efficient to provide that the primary rule governing time of supply is that the supply occurs at the time when the VAT invoice is issued, provided that the invoice is issued promptly. In practice, many suppliers issue tax invoices at the time of a supply or shortly thereafter to comply with the obligation to issue a timely invoice. The law could, for example, define the time limit as seven days after what would otherwise be the time of supply under the rules set forth above.

A supply of goods is defined as a transfer of the owner's right to dispose of tangible property, but the time of supply for the purposes of this law is fixed not by reference to that transfer, but by reference to the delivery of the goods themselves. Often, the transfer of the right will occur with the delivery of the goods, but this will depend on the precise provisions of the laws of the state relating to the sale of goods and supplies of other kinds.

Sometimes goods are not "delivered" in the usual meaning of the word. For example, a supplier sells to a customer an agreed quantity of a commodity, such as grain. The grain is held in a store by the supplier, who releases the grain only when the customer sells it to a third person, to whom the supplier delivers the goods on demand from the store. In such a case, not only are the goods not delivered to the customer, but they are not appropriated to the customer either. Cases such as this could be dealt with in regulations. Those regulations might be based on the legal provisions of the state dealing with the transfer of ownership of goods in situations where the transfer does not involve delivery.

[84]Special considerations may apply in some transition countries where there are serious problems of interenterprise arrears. *See generally* Summers & Sunley, *supra* note 9. Many of these countries operate VAT on a cash basis, or provide that the taxable event occurs at a specified time after the events referred to in the text. For example, in Georgia the taxable event occurs 90 days after the date that goods are shipped or services are performed, or, if earlier, at the time of payment. A complete discussion of the issues is beyond the scope of this chapter, but some general principles can be stated. First, it is critical that the rules for time of supply be identical for the output tax and input tax of a particular taxpayer. If a taxpayer is allowed to pay output tax on a cash basis, the taxpayer should not receive credit for input tax until the taxpayer makes payment for supplies. Second, as a general matter, to avoid claims of input tax in advance of output tax being paid, it is best to have a single rule that applies to all taxpayers, perhaps with limited exceptions, such as for small taxpayers.

Where payment is made in advance of goods being delivered, the supply should be considered as taking place on the date of the payment to the extent of its amount. The aim is to ensure that the VAT liability arises as an advance payment is made and does not await any transfer or dealing with the goods. Otherwise, advance payments could be used as a means to avoid or delay the payment of VAT. This may happen, for example, where an advance payment is made, but no invoice is issued. If the goods are delivered, it may be said to be a loan for which no payment is claimed pending the more formal agreement. This more formal agreement never occurs, thus leaving the supplier with an advance payment that apparently does not relate to any supply and leaving the person supplied with the use of goods for perhaps a long period.

The reference in the preceding paragraph to a supply taking place to the extent of the amount of the payment implies that where only partial payment is made, portions of the amount of the supply will take place on different dates. A partial payment is treated as the first occasion of supply and the occasion for any further supplies is determined in accordance with the general rules. This rule will apply separately to the situation where two or more payments are made for a supply if separate invoices are issued in respect of each payment. If one invoice is issued for the full amount due, then this will represent the applicable date for the supply for the whole sum, although payment is made in installments.

Where the "supply" of goods is actually a series of supplies occurring on a number of separate occasions, then a taxable supply occurs on each separate occasion. This is equally true for a supply of services. For example, a customer may agree to buy from a supplier the right to set up a market stall on the supplier's land each Thursday throughout a year. A supply of the use of land in this way is a taxable supply of services. Is it one supply or a supply of the use of the land each Thursday? A technical answer to this question might refer to the precise terms of the contract under which the supplier agrees to supply the use of land in this way, including the method of payment adopted. Treating each date of supply as a separate supply achieves an efficient and practical result in that the supply is regarded as occurring each Thursday if payment is made for each week only after that week. If payment is made for the whole year at a set time before the end of the year, the rule about prior payment will apply. It is normally appropriate to apply the rules by reference to the terms of the agreement between the supplier and the customer. To avoid practical problems and to simplify administration, regulations can deal in detail with cases such as this.

I. When a Supply of Services Takes Place

The considerations set out as applying to the time when a supply of goods takes place also largely apply to a supply of services. However, services are not

"delivered" or "appropriated" in the same way as goods. Instead, it is usual to determine the time of supply by reference to when the services have been rendered. This is a question of fact to be interpreted in the light of any contract or agreement under which the services are supplied.

A special case that may need a different rule is that of a supply of services over a long period or a continuing supply. If a supplier agrees to supply a customer with a continuing service (e.g., a telephone service, a supply of electricity, or continuing professional assistance), the supply might be regarded as never reaching the point at which it "is performed" until the contract between the supplier and the customer is ended, or it might be viewed as provided every minute, which would be impractical. However, payment is made from time to time, and the rule about partial payment can be applied. Alternatively, it may be that the contract between the supplier and the customer shows that the services are supplied, in effect, on a series of separate occasions. If so, it is usual to treat each supply as made when a partial payment for the supply is made or when an invoice is issued for that part. It may be that the "supply" is not one supply, but a series of supplies. If cases of difficulty arise under this general rule, special provision can be made through regulation.

J. Where a Supply of Goods Takes Place

The introduction to this chapter stressed that the VAT is usually based on the destination principle, that is, with goods being subject to VAT where they are either received or consumed. For this reason, goods crossing frontiers are subject to a regime similar to customs duties on arrival. Therefore, it is necessary to clarify where goods are received. In the case of imported goods, the adoption of customs laws will help deal with this problem. The VAT laws can adopt from the customs laws rules to determine when goods are imported and the nature of the goods imported.

In practice, most international supplies of goods are caught in this way by the customs laws of states. Location rules may also be useful within the state and to deal with exports. Often, a general rule is included in the law to locate a supply of goods where the goods are delivered or made available to the person supplied, in other words, where they are physically handed over. The fact that legal title does not pass at that time is not the important issue. For goods that are being transported, a rule is needed to determine whether they are delivered at the start or at the end of the transportation. A rule that goods are delivered where the transportation starts will accord with the common commercial arrangement that goods are at the risk of the buyer while being transported. It will also ensure that the location of the supply of goods being exported is within the state. That is necessary to provide a legal basis for providing a rebate of VAT on inputs used to produce those goods.

K. Where a Supply of Services Takes Place

Determining the location of a supply of services can be a matter of considerable difficulty, especially for international services. Customs rules cannot be used because they do not apply to services.

A second difficulty arises from the application of the destination principle. This provides that services should be taxed where they are received or consumed. However, consider, for example, the supply of legal services by a lawyer in one country to a person in another country. Where does that supply occur? The physical location of the supply may be both difficult to determine and irrelevant to the place where the supply is consumed. It might take place in the country of the lawyer, that of the client, in some third state, on an aircraft, over the telephone, or through e-mail originating in, or received in, a range of offices. If the law firm has offices in several states, the advice could be sent from any of those states. The underlying legal research, writing, and investigation could also be performed in a variety of places.

Behind those problems lies that of ensuring that a taxable person is within the jurisdiction of the state, so that the VAT can be enforced. This does not matter for imported goods, because in the last resort the goods themselves provide security for payment of the VAT. Equally, it is easy to identify a person who can be treated as importer, and duties may be imposed on that person. Another policy aspect is that fairness and neutrality require that services that originate overseas be taxed in the same way as services that originate in the state. Otherwise, overseas suppliers may be able to compete on unfair terms.

In the absence of any international agreement setting jurisdictional limits to VAT and any ready assistance in enforcing VAT in other states, there is no clear and universally accepted answer to the question of how to treat international services.[85]

Some aspects of the problem can be solved by identifying separate rules for particular kinds of supply. For example, where the services relate to land or other immovable property, it is common to treat the services as supplied where the land is situated.[86] This provides a rule consistent with usual rules on conflicts of laws, and also access to security. Similarly, a supply of

[85]The EC adopted standard rules in 1977 but was unable to adopt a simple and universal rule. *See* EC Sixth VAT Directive, *supra* note 3. As will be noted further in the text, the main rule relates to the supplier's place of business, but there are four sets of exceptions to this, two of which are permissive rather than mandatory. As a result, the location rules within the EU member states are not entirely consistent.

[86]This is the rule for the European Union. EC Sixth VAT Directive, *supra* note 3, art. 9(2)(a). The New Zealand Goods and Services Tax Act taxes supplies of services to "goods" in New Zealand at the time of supply; this includes land. NZL GST § 8. The Swiss OTVA adopts the EU rules. CHE OTVA art. 12(2)(a). The South African Value-Added Tax Act achieves a similar result by zero rating supplies connected with land in another state. *See* ZAF VAT § 11(2)(f).

transport services can be treated as occurring where the transport is supplied.[87]

Beyond this, states tend to adopt rules that locate a supply at a place of business either of the supplier or of the customer.[88] The practical problem about locating the supply where the customer is located is imposing the VAT on that supply. One answer to this is that of *reverse charging*. A reverse-charging rule treats the customer being supplied with a service originating abroad as making the supply to itself. It must then account to its tax authorities for the VAT due as output tax on that supply.[89] If the customer pays that VAT as input tax, it can claim an offsetting deduction, and will owe no VAT. However, if the customer makes exempt supplies, then no VAT credit or deduction is available.

L. Treatment of Imports

The destination principle requires a charge to VAT to be placed on all imports. This is usually done through a charging provision that parallels the one on internal supplies. The parallel provision normally adopts and adapts the laws imposing customs duties on the imported goods. The laws determining whether items are goods (inclusion in the tariff), whether they are imported (rules of origin), and when and where they are imported will serve for VAT purposes as for customs duty purposes, although it may be necessary to make clear that the act of importing occurs within the territory of the state for VAT purposes to avoid any legal problems.[90] Customs regimes, such as free ports, duty-free shops, and tax-free zones can be applied readily to VAT on this basis, the zones being regarded as outside the territory of the state.

[87]International transport services are usually either exempted or zero rated, *see infra* sec. VII(C), but a jurisdictional rule is still needed. This rule is found in EC Sixth VAT Directive, *supra* note 3, art. 9(2)(b). The Swiss OTVA, art. 12(2)(b), makes similar provision, save that a discretion is reserved to the Swiss authorities to decide cases where only part of a journey is through Swiss territory.

[88]The primary rule in the European Union is that the service is supplied "where the supplier has established his business or has a fixed establishment . . . or . . . his permanent address or [where he] usually resides." EC Sixth VAT Directive, *supra* note 3, art. 9(1). The Swiss OTVA uses the same primary rule: OTVA art. 12(1). Does this amount to the same thing as a permanent establishment for direct tax purposes? In some cases, it will. The New Zealand approach is to base jurisdiction on the residence of the supplier. NZL GST § 8(2). However, unlike income tax, this is not subject to provisions about double residence.

[89]This is not the same thing as self-supply. Self-supply means that there is no supplier—the goods or services are consumed by the person producing them. Reverse charging applies where the person receiving the supply is deemed also to be the supplier so that a charge to VAT may be applied to it. *See* GBR VAT § 8 (from which the name "reverse charge" is taken).

[90]Normally, the customs law, or general law, of a state will provide that imported goods are within the state for procedural purposes. If any doubt arises about the extent of procedural or substantive VAT provisions in the absence of such laws or their clear application, a simple deeming provision will resolve doubts.

IV. Taxable Supplies

A. Definition

A "taxable supply" is a supply or transaction on which VAT is imposed.[91] When a taxable supply is made, the person making the supply, if a taxable person, must impose and collect VAT and account for it to the tax authorities. Even if the person does not do this, the tax authorities are still entitled to collect VAT from the taxable person on the assumption that the VAT had been imposed. On what supplies is VAT imposed? The law should impose it on all supplies of goods and services within the scope of VAT and made by a taxable person unless the law itself exempts the supply from VAT.

As previously noted, to be within the scope of VAT, a supply of goods and services must also be made (1) as part of the economic activities of the supplier, and (2) against payment (or for consideration) to that person from some other person. To complete the full definition of taxable supplies, the law must also therefore define both these criteria and determine the extent of exemption. Each of these issues is addressed in this section.

B. Economic Activities

VAT is a tax on supplies made in the course or furtherance of economic activity, or, put another way, as part of a business.[92] It should therefore be confined to activities of this nature and not be imposed on other activities, such as the personal hobbies of an individual,[93] gifts made for personal reasons, or

[91]This term is used in the laws of New Zealand, NZL GST § 2(1); South Africa, ZAF VAT, and the United Kingdom, GBR VAT § 4(2). Title V of the EC Sixth VAT Directive, *supra* note 3, refers to "taxable transactions," as do Hussey and Lubick in their draft, *supra* note 13, § 211. The French CGI avoids the term, referring to *opérations obligatoirement imposables*, FRA CGI art. 256, and the French version of the Swiss OTVA follows this vocabulary. CHE OTVA § 1 (*Opérations imposables*). The term depends on whether it is appropriate to use "supply."

[92]The phrase "economic activity" is based on the EC Sixth VAT Directive, art. 4, *supra* note 3. This is chosen from the range described in this note because it is felt the term is best fitted to be translated widely. The scope of the term is wider than "business," in the sense that the term tends to imply only profitable activities. Profit is irrelevant to VAT (although the profit motive is not). Note, however, there are alternative approaches. The New Zealand Goods and Services Tax Act refers to "taxable activity." NZL GST § 6. The South African VAT Act refers to a supply "in the course or furtherance of any enterprise. . . ." ZAF VAT § 7(1)(a). The Irish VAT Act applies to supplies "in the course or furtherance of any business. . . ." IRL VAT § 2(1)(a). The United Kingdom VAT Act uses the term "in the course or furtherance of any business. . . ." GBR VAT § 4(1). Hussey & Lubick, § 211(b)(2), *supra* note 13, uses the phrase "in connection with a business," as does the American Bar Assocation draft, *supra* note 11, § 4003(a)(1). From this it will be seen that the general approach described here is widely adopted, but that there is no standard vocabulary for it.

[93]The definition of a "hobby" or leisure activity is difficult because it depends at least in part on the subjective intentions of the individual undertaking the activity and will also vary with the cultural context in which the individual is operating. The New Zealand Act excludes any activity of an individual "carried on essentially as a private recreational pursuit or hobby. . . ." NZL GST § 6(3)(a).

charitable activities with no business or commercial content.[94] In practice, the separate criterion that a supply of goods and services must be made, or treated as made, for consideration (or against payment) serves to remove many non-business activities from the scope of VAT.

The rule under which only supplies by taxable persons are within the scope of VAT has a similar effect of excluding many transactions by individuals. However, whether or not a person is a taxable person is defined by reference to the total activities of that person, so an independent definition of taxable supplies is needed. Another unclear area is that of the activities of public authorities. These may be economic activities but may also be exercises of sovereign power with no economic content (as against economic effect). Examples are the activities of the armed forces or the courts.

As a result, the law imposing the VAT usually makes it clear that only economic activities are within the scope of the tax. How this is defined varies among laws.[95] Some laws require that the supply be made as part of economic activity, or the business activities of the supplier, or in the course or furtherance of a business carried on by the supplier. Others refer to supplies made by the taxable person acting as such, that is, acting in the capacity as a taxable person making taxable supplies.[96]

Some laws offer definitions of these activities,[97] but such definitions often do not add much to the overall clarification of the scope of the law. This point will need separate consideration in individual states. The key point is that here as elsewhere the law must be interpreted and applied so that it catches all economic activity that is not deliberately excluded. Government activity, charitable activity, and personal nonbusiness activity should therefore be excluded. The extent to which this point needs to be spelled out in the law will depend on the ease with which the concept of economic activity or business activity is understood within the state.

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[94]For a discussion of the economic and legal rationales for the tax, *see* ch. 7 *infra*. This approach can lead to the exclusion of some personal consumption from the tax base. This may be justified primarily by administrative consideration, such as difficulties in allocating input credits where supplies are not made as part of a business.

[95]*See supra* note 92 (addressing the varied vocabulary and national practices).

[96]This is the key approach of the EC Sixth VAT Directive, *supra* note 3, in applying VAT to the supplies of a "taxable person *acting as such*. . . ." *Id.* art. 2 (emphasis added). This reflects the French approach of subjecting to the tax those who make, *in an independent manner*, habitually or occasionally, one or more supplies on which the VAT is imposed. FRA CGI art. 256A (emphasis added). The Swiss OTVA adopts the same focus, applying the tax only to those persons who exercise *in independent manner* a commercial or professional activity with a view to realizing receipts. CHE OTVA art. 17 (emphasis added).

[97]*See, e.g.*, NZL GST § 6(1). The United Kingdom defines "business" by implied reference to its income tax laws, *see* GBR VAT § 94(1)(using the same language as GBR ICTA § 18 (the income tax charge on business activities)), and this approach, adjusted to the local laws, might be useful.

C. Payment for a Supply

A supply is made for payment, consideration, or compensation[98] if the taxable person making the supply receives, or is entitled to receive, payment for the supply.[99] For this purpose, it does not matter in what form the payment is made. An exchange of goods is a supply for payment or consideration by both parties to the bargain, as is a supply of goods in exchange for the provision of services by the person receiving the goods.[100] In addition, it does not matter who makes the payment. It will usually come from the person receiving the supply, but the source is irrelevant. Therefore, some laws make it clear that all forms of payment are to be included as payment or consideration for the supply, even if this includes grants made by public authorities or other third parties.[101]

The concept that a supply is within the scope of VAT only if there is payment or consideration for it follows from the fundamental nature of the tax as one imposed on the value added by a transaction. If a supply does not result in gain for the supplier, directly or indirectly, then no value is added in making the supply. By contrast, the same reasoning argues that the consideration should include all forms of payment received by the supplier, in cash or in kind, whenever and however paid, and regardless of who pays them.

This definition is usually used as the definition of the taxable value of the supply, that is, the amount on which the VAT is imposed. Both efficiency and fairness therefore argue for a comprehensive definition.

Liability for payment of VAT on a supply does not depend on the transaction complying with provisions of the contract law or commercial law of the state. The obligation arises, in the usual case, because as a matter of fact, a tax-

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[98]"Compensation" sometimes carries the meaning of pay for employees, which is not intended here. The alternatives are provided because in a common law country the term "consideration" normally conveys a sense of the consideration required as part of the necessary elements of a contract between two parties. "Consideration" has a wider meaning than this in a VAT context, because it includes payments from third parties and payments made even when, for some technical reason, no contract has been created.

[99]Note the discussion at the text accompanying notes 25–28, *supra*, on the terms used here. The wording "payment" is preferred to "consideration" for the reasons already discussed. There is no consistent usage internationally.

[100]Except where the person supplying the services is an employee of the person supplying the goods, in which case the supply of the goods is treated as a supply, while the supply of services is not treated as a supply for purposes of VAT. *See supra* sec. III(D).

[101]The inclusion of public subsidies "directly linked to the price of . . . supplies" is found in the EC Sixth VAT Directive, *supra* note 3, art. 11(A)(1)(a), but is not found in all the laws of the EU member states. Subsidies not linked to prices or to any specific service or goods produced by the person being subsidized will not be consideration or payment for any specific item and are therefore not within the scope of VAT. It is possible that some direct tax provisions might amount to subsidies within this provision, although the writer is not aware of any practical example of this. It might be considered preferable to exclude such possibilities from the VAT law by providing an exemption for subsidies.

able person has made a supply and has received payment for it. The legal obligation to supply or pay is not relevant at this level. It becomes relevant if no payment is received, although the supplier is entitled to receive it, because the timing rules of VAT, discussed above, generally impose liability to pay VAT whether or not payment has been made at the time the VAT is due. Failure to pay should require a subsequent revision of the overall VAT liability of the taxable person. This is discussed below.[102]

Of course, if *A* pays *B* to make a supply to C, it must be asked who is being supplied. Is it A or C? This will depend in part on the laws of contract of the state. However, the amount paid by A is payment or "consideration" for VAT purposes even if there is no contract between A and *B*.[103]

D. Transactions Where No Payment Is Payable

In principle, if there is nothing paid or payable for a supply, then it is not a taxable supply. Safeguards are needed to prevent the operation of this principle from allowing transactions to escape a charge to VAT in inappropriate situations. For example, a taxable person who makes gifts of goods acquired for the purpose of the person's economic activities should be brought within the scope of the tax. Likewise, an individual trader who personally uses goods purchased for the business should also be made subject to VAT on the use. The reason for this is that the trader will have received a VAT credit (or deduction for input tax) for the goods on purchase. If there is no offsetting output tax, then there is a hidden subsidy of the trader's personal consumption and gifts.

It is therefore wise to extend the definition of supply for consideration to cover certain nonbusiness uses of a supply. The following transactions or occasions should be considered for this purpose:

(1) personal consumption by an individual of goods purchased for the individual's business, including consumption by the individual's family and household;

(2) gifts of goods, or the use of goods, made by a taxable person where the goods were purchased solely for the person's business, and the gifts are not themselves for business purposes (e.g., advertising or trade samples); and

(3) supplies of goods made without charge to employees of the taxable person.

For example, a shopkeeper who purchases food as part of her or his business but later uses the food for personal consumption might be obtaining an unfair advantage. The shopkeeper will treat the purchase of the food as a sup-

[102]*See infra* secs. VI(E), VII(L).

[103]This complication does not arise where states do not require "consideration" as part of a contract. It is another example of a concept that does not readily translate between languages and law systems.

ply on which any VAT paid can be reclaimed. When the shopkeeper consumes the food, if there is no charge to VAT, the shopkeeper will have been able to obtain a credit without any charge of tax to someone else. It is appropriate to provide that the supply or use of goods in this way is taxable. The shopkeeper will therefore have to account to the tax authorities for the value of the goods consumed as if they had been sold. At a minimum, the effect is to prevent excess tax credits from being given.

This rule will apply equally to the use of durable goods. For example, where the shopkeeper uses partly for private purposes a car that is regarded as purchased as a business asset, there should be an appropriate adjustment in the accounts of the shopkeeper to reflect this. It may be desirable to provide more detail of how such accounting should take place by regulation.

These rules usually apply to supplies of goods but not to supplies of services.[104] This is deliberate and is intended to stop any attempt to tax, for example, the situation where a builder repairs part of the builder's own home or a professional person applies part of her or his professional expertise to her or his own benefit. Attempts to tax such events will prove impracticable and may be potentially unfair, because the events may be part of the private activities of the individual and often do not involve any claim for tax credits. If goods are used as part of a supply of services (e.g., by a builder), then the rule should apply to the goods unless, as a practical matter, the goods are incidental to the services.

A rule that imposes VAT on a supply for which there is no consideration must also provide a taxable value to that supply. Alternative measures for determining that value are considered below.[105]

The general rule is sometimes made subject to an exception for advertising, trade samples, and trade use. A business may make gifts of goods it supplies, or make available free use of those goods, to customers as part of the business without consideration in such a way that the expense of providing the goods or the use of the goods is properly regarded as a business expense. This exception is designed to protect those practices from being subject to VAT if it is considered inappropriate to impose a charge on these gifts. It is for the tax authorities to consider whether more detailed guidance is needed to ensure that this provision is used appropriately, but not abused, by taxable persons.

E. Supplies Where Payment Is Not Full

Together with transactions for which no payment is made, but where it is deemed to be made, mention must be made of supplies where the payment

[104]This is another example where the theoretical tax base (consumption) does not correspond with the legal tax base as typically defined. *See* ch. 7 *infra*.

[105]*See infra* sec. VI(D).

made is less than the full payment or consideration that should, or might, be paid in the open market. If some payment is made, then the supply is within the scope of VAT. However, a partial payment is not itself a proper measure of the value added by the supply, and an alternative measure of that value added is needed. This was addressed previously.[106]

V. Exempt Supplies

A. General Comments

All states have found it necessary, when introducing a VAT, to create exceptions to the breadth of the potential scope of the operation of VAT. The standard way of dealing with this is to exempt certain forms of supply that are otherwise within the scope of VAT from liability to VAT.[107] By definition, exempt supplies are not taxable supplies.[108] By contrast, some states have adopted the practice of listing those supplies that are subject to VAT, rather than adopting the approach here.[109]

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[106]*See supra* sec. III(H).

[107]This pattern applies throughout the European Union under the EC Sixth VAT Directive, *supra* note 3, Title X. It is also the pattern explicitly adopted by New Zealand, NZL GST § 14, and the countries that followed the New Zealand approach of minimizing exemptions. *E.g.*, CAN GST § 123(1) (definitions of supply, taxable supply, exempt supply). The French CGI approach is similar, first stating the taxable transactions in broad terms, then listing the exemptions. FRA CGI arts. 256, 261; *see also* CHE OTVA arts. 4, 14 (first, setting forth the taxable transactions in a short, broad form, and then setting forth the exceptions).

[108]The terms "exempt supply" or "exempt transaction" are widely used in English-language texts. *See, e.g.*, EC Sixth VAT Directive, *supra* note 3, Title X ("exemptions"); IRL VAT, §§ 1(1), 6 ("exempt activities"); NZL GST §14 ("exempt supplies"); South Africa, ZAF VAT § 12 ("exempt supplies"); GBR VAT § 31 ("exempt supplies"); *cf.* Hussey & Lubick, *supra* note 13, § 211(c)("exempt transactions"). The French approach is the same, the equivalent term being *opérations exonérées*. FRA CGI art. 261. This stands in contrast with the Swiss approach in the OTVA, where the exemptions are stated as operations outside or excluded from the scope of the tax. CHE OTVA art. 14. This drafting approach therefore limits the scope of the tax, rather than carving out areas of exclusion within it. It is the main difference between the Swiss VAT and that of the EU states that surround it.

[109]For example, Argentina. ARG IVA art. 3. The VAT law in the People's Republic of China is also limited in scope, *see* CHN VAT art. 16 (items exempt from VAT), but this is because the VAT is deliberately not intended to have the universal coverage assumed in this chapter. Save where the intention is to limit the tax (not the approach adopted in this chapter or in most states), the approach adopted in the chapter is to be preferred to the alternative. This is because the approach of listing in some detail the kinds of transactions taxed inevitably means that any new kind of transaction or any transaction not specifically considered falls outside, rather than within, the scope of VAT. This renders the structure of the tax more open to the activities of those who plan to avoid tax and who will seek to identify and exploit the gaps in the list. A specific list of exemptions means that the "gaps" are deliberate.

State practice on the exemption of supplies is inconsistent. Few common themes emerge. When VAT was first introduced, it was more common than it is now to apply VAT to supplies at a range of rates, including very low rates, and also to exempt a wide range of supplies. Since then, state practice has tended to reduce the range of supplies exempted and also to cut down the range of reduced rates of VAT and to increase the levels of the lowest rates.

Broad policy considerations, including ease of administration, the revenue levels produced by VAT compared with other taxes, the trade-off between the rate structure of VAT and the base on which those rates are levied (the broader the base, the lower the rates), fairness, and economic neutrality of the tax, all argue for minimal use of exemptions.[110] Political considerations in individual states and, in particular, the political perception of social considerations have been used to argue to introduce or preserve exemptions. An additional consideration to a newly introduced tax is that it is easier to introduce a broad-based VAT when the tax is first operated than to attempt to remove exemptions once established.[111]

A few states have distorted the VAT framework even further by allowing zero rating of internal supplies.[112] As discussed below,[113] zero rating of exports and international supplies is very common. It is justified by the destination principle on which international transactions are subject to VAT. This does not apply to internal supplies. Zero rating may also be described as "exemption with credit," which is why it is mentioned here. To keep the discussion of exemption separate from the complication of zero rating, comment on zero rating is limited to the section on rates of VAT.

B. Effect of Exemptions

It is often assumed that "exemption" results in the reduction of the VAT burden on a supply. This is true if the person supplied is a consumer and is not receiving the supply as part of a business. It is not true if the person supplied is

[110]*See generally* Tait, *supra* note 2, ch. 3.

[111]This was not true when the first VAT laws were introduced and when the EC first adopted VAT. New Zealand, in 1977, was the first state to adopt a form of VAT (deliberately named Goods and Services Tax to avoid comparison with the British VAT) with minimal exemptions. The New Zealand example has been followed in Singapore. *See* SGP GST.

[112]The main state to do this is the United Kingdom. GBR VAT § 30. The extent to which zero rating was and is permissible under EU law has long been a matter of dispute. *See, e.g.*, Case 416/85, European Commission v. United Kingdom, 1988 E.C.R. 3127 (where the Commission successfully challenged several categories of supplies previously zero rated by the United Kingdom—in particular, many supplies of land and buildings). *See also* NZL GST § 11. Ireland also zero rates some categories of internal supplies. IRL VAT second sched. In addition to exports, Italy zero rates certain supplies assimilated to exports, for example, supplies of airplanes to airlines engaged primarily in international transport. *See* ITA IVA art. 8 *bis*.

[113]*See infra* sec. VII(D).

a taxable person. Exemption of a supply to a business results in an *increase* in the burden of VAT on the supply. The reason for this is that the person running the business can offset the VAT against the VAT charged by the business, so claiming a full rebate for any VAT. The person making the exempt supply will probably have had to pay VAT on some part of the supplies made to it and will therefore have to pass some VAT on to the business as part of its price. It is this VAT that can be recovered if the supply is subject to tax, but that cannot be recovered if it is exempt. To avoid the distortions caused by this failure to recover, it is good policy not to exempt the types of supply that are typically made to business.

C. Specific Exemptions: Internal Supplies

Although there are strong policy arguments for minimizing exemptions, no state has succeeded in removing all exemptions from the law. Even New Zealand, which has been most successful in curbing the extent of exemptions, has maintained some.[114]

1. *Land and Buildings*

Transactions involving land and buildings are commonly exempted. As previously noted, many states provide that a sale of land, or other transfer of the title to land, is outside the scope of VAT. Other states achieve the same effect by exempting these supplies. Further, the law needs to deal with supplies of services related to land. The main service is the use of land, or leases or tenancies of land. For the same reason that land itself is exempted, it is common to find that leases and lettings of land are also exempted.[115]

At the same time, there is no strong reason for exempting commercial uses of immovable property, such as accommodation in a hotel. Accordingly, states restrict the extent to which leases, licenses, and tenancies are exempt. This may be done by excluding categories of land use (such as holiday use) from the exemption or by setting a minimum time period for exempt leases and tenancies (perhaps two months).[116]

2. *Supplies by Nonprofit Organizations and Individuals*

Many states provide exemptions for social goods and services, that is, supplies that are made to individuals and that do not form, or do not usually form,

[114]The New Zealand exemptions are (in summary) financial services, certain supplies by nonprofit bodies, certain supplies of accommodation and land, and supplies of gold and fine metals. NZL GST § 14. *Cf.* SGP GST fourth sched. (under which the only major exemptions are financial services and certain residential real estate transactions).

[115]*See infra* ch. 7.

[116]*See*, *e.g.*, the extent of the exemption and the exceptions from it, in the EC Sixth VAT Directive, *supra* note 3, art. 13B(b). This approach has been widely adopted.

business supplies. An example of this is the supply of health services that are by their nature supplied to individuals. Many social supplies are outside the scope of VAT because they are not made as part of a business or are not made for payment or consideration (as with free health supplies from a state authority). The only supplies that fall within the scope of an exemption are those that would, but for exemption, be within the scope of VAT. A compromise recommended in this context is to exempt social activities of nonprofit organizations[117] and also of individuals providing supplies in similar circumstances to these organizations. If a charity provides hospital treatment or a religious organization provides education for a nominal fee, this can be exempted.

Similar activities carried out by an ordinary commercial organization will not be exempt. As a result, nonprofit bodies may be tempted to engage in commercial activities in such a way as to gain unfair advantage over ordinary suppliers. It is not enough to justify exemption that those profits are used by the organization for nonprofit purposes. For example, a religious organization that runs profit-making shops to help finance repairs to a religious building should be subject to VAT on the goods it sells. A distinction must accordingly be drawn between the social or charitable activities of nonprofit bodies and their commercial activities.[118]

3. *Financial Services*

Exemptions of financial services[119] are also included to avoid problems of complex administration, for example, where it is difficult to identify the value added within a transaction. In principle, any fee or charge for a financial service should be liable to tax. The difficulty is in identifying that charge separately from the other elements that are included when determining levels of payments of interest or fees. Those other elements include the real cost of the capital involved, the risk to the lender of undertaking the transaction, and the

[117]This requires a definition of "nonprofit" organization or body. However, such definitions will usually be needed for income tax and for general legal purposes, so these may be used for VAT also.

[118]This is similar to the approach usually taken in an income tax. *See* vol. 2, ch. 19. The distinction is difficult to draw in many instances. For example, is a book-publishing activity carried on by a church or educational institution charitable or commercial in nature? A relevant criterion is whether treating an activity as exempt would distort competition with commercial activity.

[119]The exemption is usually focused on primary financial services, that is, services supplied direct by banks and finance houses. Definitions of services exempt under this category usually take the form of a list. *See, e.g.*, EC Sixth VAT Directive, *supra* note 3, art. 13B(d)(which has been followed by the Swiss OTVA art. 14(15) and in several other European states); NZL GST § 3 (followed in ZAF VAT § 2). The phrase "primary financial services" is not a formal phrase, but is intended to emphasize that it is the primary or core financial services, not all services connected with finance, that are exempted. One test is whether the supplier of the service is at risk. For example, the supplier of loan credits or banking services is at risk of loss because of the services. A provider of advice about where to borrow money or what banking services to use is not at risk. The exemption is normally considered relevant to the former category only.

inflation rate operative during the transaction. Transactions involving these elements may be termed primary financial services, and nearly every state exempts these forms of financial services for this reason.[120]

D. Using Alternative Taxes

The exclusion of categories of supply from the scope of VAT, or the exemption of those categories, does not mean that those supplies need be excluded from all indirect taxation. Some examples may be given of this practice. It is noticeable that states, finding it less practicable to impose a VAT on forms of internal and international supply, are increasingly adopting other taxes to make good the revenue loss.

Examples of internal supplies taxed in this way are taxation of transactions involving land and buildings by imposing stamp duties or transaction taxes or high registration fees on the documents used for the transfers; exemption of insurance services, but the imposition instead of taxes on insurance policies or premiums; use of income taxes and other direct taxes to ensure taxation of payments for financial services (particularly interest) in place of the almost universal exemption from VAT of those services; exemption from VAT for betting and gaming, offset by specific taxes on those activities; exemption of activities where there is a state monopoly (e.g., postal services and some transport services), with fiscal adjustments to prices being used to the same effect.

Examples also occur of taxes being imposed on those international supplies that are exempted or zero rated by reason of the destination principle or pressures of competition. An increasingly common example is taxation of airports and airline tickets. Another is tourist taxes of various kinds, such as exit taxes when tourists leave the state. Further discussion of this topic is beyond the scope of this chapter.

E. Exemption of Diplomatic Activities

States generally have accepted treaty obligations to exempt certain supplies or imports as part of the recognition of diplomatic and consular immuni-

[120]Several states have considered the taxation of financial services in detail, including New Zealand, Canada, and the United States, but found themselves unable to resolve satisfactorily the practical and conceptual problems raised by this charge to tax. There is an unresolved disagreement between experts about whether, and to what extent, interest should be subject to VAT. It is argued by some that the whole interest should be included in the potential charge to VAT. Others argue that the only amount that should be included is the difference between the interest rate that, for example, a bank charges its customer and the interest it pays the people that lend to it. *See* Tait, *supra* note 2, at 92. Russia is the only state to have applied VAT to any form of primary financial service. The European Union has been considering restrictions on its broad exemptions.

ties and of similar immunities for international organizations.[121] These involve immunity from taxation for the embassies and consulates and for the recognized diplomats and consuls. These immunities are normally operated on a reciprocal basis and are based on the provisions of the international conventions that set out the required immunity from taxation.

In many states, no express provision is included in the VAT law on this matter, because the exemption is provided under the terms of international obligations that are part of national law. If such obligations are not self-executing in a particular country, or if the country wishes to clarify or expand on the exemptions accorded, a specific exemption needs to be provided in the VAT law.

F. Exempt Imports

International practice recognizes agreed categories of goods that are exempted from customs duty on import. Practice on this is well established and ranges from the import of a limited quantity of goods bought duty free in other states to exemption of gifts to charities or similar organizations. It is for consideration how far those exemptions should also apply for VAT purposes. Some are appropriate because of the underlying reason for the exemption from customs duty. Others would not be appropriate because they would create unfair competition with those supplying similar goods from within the state.[122] Principles of fairness and efficiency argue for minimal exemption from VAT even where customs duty exemptions apply, particularly if there is a business purpose behind the import. Whatever the policy adopted, it is convenient in most cases to frame the VAT exemptions on imports with the customs duty exemptions in mind, so as to avoid unnecessary inconsistencies.

One particular category of import has caused particular concern in developing states and the economies in transition. This is the import of foreign-produced machinery and equipment for the use of local businesses. In principle, such items should be subject to VAT when imported, if also subject to VAT when produced locally. In some states, there is no local capacity to produce such items, and importers lobby strongly for VAT exemption. The imposition of VAT would not be much of a problem for taxpayers if a credit for the tax were immediately allowed, but there are often restrictions on such credits (e.g., a delayed credit for capital goods, a requirement to carry over excess credits, or a de facto difficulty in obtaining refunds). If an exemption is granted for

[121]The main treaties are the Vienna Convention on Diplomatic Relations, Apr. 18, 1961; the Vienna Convention on Consular Relations, Apr. 24, 1963; and the agreements and conventions relating to individual international organizations. The exemption often takes the form of zero rating. *See infra* sec. VII(D).

[122]For example, an exemption on the import of manufactured goods will distort competition with any similar goods produced internally unless they are also exempt. There are, however, only limited circumstances in which it may be appropriate to exempt the domestic production of manufactured goods.

pragmatic reasons, it should be restricted in scope and time and conditional on the genuine business use of the equipment.

G. Problems Caused by Exempt Supplies

While, as discussed above, for both political and technical reasons it may be necessary to exempt a number of different types of supplies, exemptions create significant distortions beyond those that may be obvious (i.e., the fact that certain supplies to final consumers are favored over others). One of these distortions—the problem of exempt supplies made to businesses that are VAT taxpayers—has already been discussed above.[123] Another important problem is that of input credits to a business that makes both taxable and exempt supplies.[124] That problem involves the conceptual and practical difficulty of determining which inputs are attributable to exempt supplies. Inputs to exempt supplies cause an additional problem; namely, they create an incentive for a person making exempt supplies to supply itself through its own employees, instead of purchasing inputs from others. For example, a bank whose supplies are entirely or largely exempt financial services may enter into a contract with a security company to provide security guards. The security company will charge VAT to the bank if it is a taxable person, and the bank will be unable to recover the VAT as an input credit.[125] The bank would have an incentive to hire security guards as its own employees. Because employee services are outside the VAT, this maneuver quite legally minimizes the bank's tax costs. In response, some states have imposed VAT in certain cases of self-supply by taxpayers.[126] However, antiabuse rules of this kind are of necessity limited in scope and cannot be generalized unless the VAT is fundamentally restructured (such as by treating all employee services as taxable). In addition to such legal avoidance, exemption leads to temptation for evasion: while normally businesses do not have an incentive to avoid VAT on their supplies (except as part of a scheme of tax evasion that would also involve the understatement of sales), a person making exempt supplies has an incentive to pay its suppliers under the table.[127] Widespread exemptions can therefore undermine the integrity of the VAT as a whole. This is a consequence of the invoice-credit method of VAT. The

[123]*See supra* sec. V(B).

[124]*See infra* sec. VII(G).

[125]*See id.*

[126]*See* GBR VAT sec. 5; The Value Added Tax (Self-Supply of Construction Services) Order 1989, now SI 472, *reprinted in* Butterworths VAT Handbook 1995, at 381. The order treats a taxable person who constructs a building for use in the taxable person's business as making a supply to itself. This will give rise to tax liability only if the person is not able to claim a full input credit for the supply.

[127]For example, in Georgia restoration work on churches is exempt. A contractor hired to restore a church has an incentive to pay its suppliers under the table. If the contractor paid VAT on its supplies, it could not recover the VAT as an input credit.

method works reasonably well if all supplies are taxable, but starts to break down when some supplies in a chain are exempt.

VI. Taxable Value of Supplies

A. Charge to VAT

VAT is designed as a tax levied as a proportion of the value added on any taxable supply. It is therefore necessary to attribute a value (referred to as "the value"[128]) to all taxable supplies to ensure that this objective is achieved. To be consistent with the fundamental principles of the tax, the value to be taxed must reflect the value added by the supply.

B. Value of Internal Supplies

The general rule for valuing a supply for VAT purposes is to value it at the total of all payments, or consideration, that the supplier receives or is entitled to receive as a result of the supply. In other words, the value is taken as the actual realized value. This relates to the requirement, already discussed, that there be payment for a supply in most cases for it to be within the scope of VAT. All forms of payment or consideration, whether paid by the person supplied or some other person, are relevant for that purpose. They are also relevant in determining the total value.

For the purposes of the general rule, it is irrelevant whether the total payment represents a "good" or a "bad" price for the supply, as long as it is a genuine price and not a sham. It is common to find rules that displace the price paid in certain cases, but in most commercial transactions it is a matter of indifference to the tax authorities if the price is "too" high or low. This is because any distortion of the price is neutralized if both the supplier and the person supplied are fully taxable persons. Any increase or decrease in the VAT collected will then be offset by a similar increase or decrease in the VAT credit or input tax deduction claimed. The matter is only of concern if the high or low price increases the overall amount of input tax available for deduction or decreases the overall collection of output tax. This will happen only where one party is a taxable person and the other is not.

[128]"Value" is the simplest English term (and is used, for example, in New Zealand, NZL GST § 4, and the United Kingdom, GBR VAT § 19), although "taxable amount" is also used in the Basic World Tax Code, Hussey & Lubick, *supra* note 13, § 221. As the tax is a "value-added" tax, it seems most appropriate to reflect the core wording here. The term "taxable value" is another option but is not used here because it merely adds to the length of the law without assisting understanding. The French CGI uses *base d'imposition*, art. 266, and the Swiss (French) OTVA refers to *base de calcul*. CHE OTVA art. 26.

C. Tax Inclusive vs. Exclusive Base

The value of a supply should be taken as including all other taxes paid on that supply. VAT is not an alternative form of excise tax or customs duty, but is a separate tax. Both customs duties and excise taxes reflect the state's separate decisions to increase the price of the dutiable and excisable products by the amount of the duty or tax. That represents the value of final consumption of the goods for VAT purposes and is therefore the basis of the value for VAT.

If it is felt that the combined effect of excise duty and VAT on a product is too high, the answer lies in adjusting the level of excise duty, not of the VAT. This is not only consistent with principle, but is also both simpler to administer and less distortionary. The alternatives would be either to exempt the items from VAT if subject to duty or to calculate the VAT on the price without counting the duty. Both would add significantly to the overall administrative burden on suppliers and the tax authority for no fiscal purpose.

One proviso to the general rule is needed. The law should state that the value does not include the VAT itself. Otherwise, a circular element is introduced into the calculation. The amount paid by the customer for a supply may be defined as including or excluding the VAT. For example, the price may be stated as "100." In some states, it is assumed in such a case that the VAT is to be added to that price, so that the full amount paid by the customer is 100 plus VAT.[129] In other states the assumption is the reverse of this, namely, that if the price is stated as "100," then that is the total that the customer is obliged to pay, including VAT.[130] In the first case, the value of the supply is, as defined above, 100. In the second case, the value *plus the VAT* is 100. For example, if the rate of VAT is 10 percent, then in this case the value is 90.9, and the VAT payable is 9.1 (rounded to the nearest decimal point).

The decision whether to include or exclude the VAT in determining the relationship between the value and the total consideration will need to be taken into account in framing the VAT law. However, it is a rule that belongs to the commercial law or consumer law of the state, not the VAT law. Any measure penalizing the exploitation of the rule to overcharge customers also belongs in a law other than the VAT law.

D. Fair Market Value of Supply

Where the person supplied is not a taxable person, or not a fully taxable person, but the supplier is a fully taxable person in respect of the supply, there may be a temptation for taxpayers to understate the price to avoid creating input tax that the person supplied cannot reclaim. There are also cases[131] where a supply is treated as being made for payment, even though nothing is paid or

[129]This is the standard approach taken with regard to sales taxes in the United States.

[130]This is the standard approach taken in Europe.

[131]*See supra* sec. IV(D).

payable. In both cases, it may be considered appropriate to override the general rule.[132] Instead, value would be based on an independent measure of the value added by the transaction. This would normally be the open market price, or arm's-length price, of the supply. Again, clear rules will be needed to apply an alternative basis of valuation.

Temptation to adjust prices may also arise in the case of mixed supplies or supplies where a number of different parties are involved. For example, where a taxable person is acting on behalf of someone else, those transactions undertaken as agent for the other person may not be subject to VAT because the principal is not a taxable person. Here, close attention needs to be paid to ensuring that the total payment is shared properly between the different parts of the total transaction. This does not require the *total* payment to be altered. Rather it calls for careful auditing.

The open market price—or some other objectively determined price—will need to be determined in any case where a supply is treated as made for consideration although no consideration is actually paid or payable. It will also be needed in any other case where the law allows the tax authorities to override or ignore the actual price.

Put at its broadest, the power to override may be justified in any case where the relationship between the supplier and the person supplied is such that the price fixed between them may be open to pressures other than market pressures and where one or both parties are not fully taxable persons in respect of the supply. This will, for instance, include transactions between related persons. More generally, this issue can be addressed through legislative provisions similar to those found in income tax law (and customs law).[133]

E. Adjustments and Rebates

The rules to determine value need to be simple and easy to apply at the moment of sale, without delay or difficulty. They are applied in millions of transactions by everyone actually making supplies and fixing prices. Save for specifically documented adjustments, the person making the sale or supply must be able to determine what figures to put on the VAT invoice at that time without any need to revise them.

The rules determining value must therefore deal clearly with any adjustments, such as discounts, made to prices. For example, if goods are sold as "normally $100, but $90 for today only," what is the price? The answer is that today

[132]This is a common, but not universal, practice. For example, in Japan there is no power to override the value determined by the parties. Instead, the Japanese tax authorities may use the "substantial attribution" rule (in CLT art. 13) to attribute the value to the person who is in substance, rather than in form, receiving it. *See supra* note 54.

[133]This topic, together with the problems of definition within it (such as the problem of defining a market price), is of considerable concern in the income tax. It links, in particular, to the problem of transfer pricing. This topic receives thorough discussion elsewhere (*see* vol. 2, ch. 18) and is not covered further here.

the price is $90, that is, the value actually added by the transaction. However, tomorrow, it is $100, unless the lower price is actually agreed upon. For this reason, the value should be the price after any discounts.

The position is more difficult if the price for a sale is "$100, but only $95 if you pay within seven days." In this case, the customer might pay either $95 or $100, and the supplier does not know at the time of sale. Here, the usual practice is to take the lower price, which is all that the customer needs to pay. The extra $5 might be regarded as a fee for late payment (and as such might be regarded as payment for an exempt financial service). Another complication is the use of vouchers or tokens. For example, a person buys an item at a shop and pays the full price, but also receives a voucher good for a reduction of $10 in the price on purchase of a second item. The sale of the second item will then be discounted to this person, even though others pay the full price. The value added, in the case of the sale to this person, is always the discounted price. This is both consistent with the principles of the tax and the most practical answer.

Further complications arise where the effect of a discount, or an arrangement on purchase, results in a later adjustment. In this case, no account should be taken of the change in connection with the first transaction. This should be dealt with as a separate transaction and treated in the same way for administrative reasons as a separate supply, even if the supplier pays money to the person supplied and therefore reduces the net consideration. When the adjustment occurs, the VAT should be added, or rebated, in exactly the same way as on the original supply. It is important from the point of view of the tax administration that there be no reason to alter the VAT invoice issued in connection with a transaction. Once the VAT invoice is issued, there should be no provision allowing for its alteration, except for the correction of an error. For example, if a customer pays $1,000 and an invoice is issued for $100, then a corrected invoice should be issued upon discovery of the mistake.

F. Value of Imports

In the special case of imports of goods, it is standard practice to use the customs value of goods as the value for VAT, subject to specific adjustments. The "customs value" generally represents an internationally agreed upon approach to the valuation of goods subject to customs duty and therefore minimizes the scope for difficulty or dispute in levying VAT on the import. It also simplifies the operation of VAT on imported goods and allows the VAT to be calculated at the same time as the customs duty and by the same officials. The customs approach may also be used when fixing the value for VAT of goods exempted from customs duty but liable to VAT. Attention has already been drawn to the advisability of aligning as far as appropriate the VAT exemptions on imports with the exemptions that apply under the customs code.

Two standard adjustments are needed to convert the customs value of goods to the value for VAT. First, consistent with the policy discussed previ-

ously on internal supplies, the value for VAT should include the customs duty itself. Excises levied on imports should likewise be added to the VAT base. Second, the customs duty will usually include all freight and handling charges and similar costs to bring the goods into customs control. The obligation on the person delivering the goods to the state may include further charges and the cost of inland freight to the place of delivery within the state. If the goods are not handed over at the time or place of customs clearance, then the value for VAT should include all additional freighting and other charges incurred up to the time of delivery to the customer. This is, again, consistent with the approach taken on internal supplies. If these extra charges are separate, then they may need to be dealt with as separate supplies.

VII. Payment of VAT

A. Determining the Amount to Be Paid

Two important elements remain in order to establish how much VAT the taxable person must pay to the tax authorities. The first is the rate of VAT to be paid on the value of any supply. This, together with issues already discussed, deals completely with the question of determining the output tax on any supply. The second is the offset of input tax against output tax to identify the net VAT payable. These topics, and associated issues, are discussed in this section.

B. Rates of VAT

Countries' practices in setting the rate or rates of VAT have varied widely over the 40 years since the tax was first introduced. Some countries have imposed six or more effective rates at the same time. The result has been some confusion as to the purpose of the tax and considerable administrative complexity and market distortion. Recognition of these problems, and of the underlying policy issues, has led states to abandon complex rate structures. A detailed discussion of the relevant policy issues is beyond the scope of this chapter.[134] However, recent practice may be noted, and best practice commended.

It is now generally accepted that the VAT should not be used as a vehicle for imposing luxury rates of indirect tax.[135] If a state wishes to impose high rates of indirect tax on specific goods or services, then the generally easier way

[134] *See* Tait, *supra* note 2, ch. 2.

[135] This is expressly excluded within the European Union. EC Sixth VAT Directive, *supra* note 3, art. 12. Several EU states that used to impose luxury rates of VAT have therefore withdrawn them. Some African countries still use luxury rates (in some cases first introduced following the French example, although France itself has since adopted the EU rules). An interesting example of a VAT-style tax being expressly geared at luxury items is the Wholesale and Luxury Tax in Venezuela. VEN IC. The VEN IC is levied at a standard rate and at two additional luxury rates. *Id.* arts. 56–58. The additional rates are applied to items such as cars, tobacco, jewelry, and cable TV. *Id.* arts. 57–58.

to do so is with a separate excise duty or tax.[136] This is the usual route now chosen. Internally, it simplifies the identification of luxury goods. Internationally, it avoids any accusation that differential rates of VAT are being used for discriminatory purposes.

It follows from this that VAT will have a main or basic rate and one or more lower rates. The main rate of VAT is an important matter of fiscal policy in any state and the level varies significantly among states.[137]

Clearly, the higher the main rate, the more pressure there will be from lobby groups to apply one or more lower rates to specific items. In practice, it should be remembered that no long-term social objective is achieved by setting any rate other than the main rate on goods or services supplied to fully taxable persons. There may be a cash-flow advantage to them in not having to pay quite so much VAT before making a claim for the VAT credit for deductible input tax, but in the longer run the VAT they pay is reclaimed against their own output tax as a VAT credit for input tax and thus has no residual effect.

Arguments for lower rates therefore concentrate on socially important goods such as food, and socially important services that are not exempted or outside the scope of VAT. Of course, there is a cost in VAT forgone in allowing a lower rate, and any lower rate will usually cause either the main rate of VAT to be higher than it otherwise would be, or other taxes to be higher, given the total tax revenue. Some states have decided that it is better to collect VAT at one rate and to deal with such pressures in other ways (through subsidies or adjustments in social security entitlements), while others have opted for a lower rate. Again, practice used to involve a range of lower rates but has tended to simplify toward one lower rate (as is happening within the European Union) or none.

C. Zero Rate

In addition to the main rate of VAT and any lower rates, it is normal practice for states to have a zero rate of tax, although it may not be called this.[138] A zero rate means that, while no VAT is due on the supply, the supplier remains

[136]In making such a decision, however, one would have to bear in mind the manufacturing process for the goods in question and, accordingly, the suitability of excise administrative procedures compared with procedures under the VAT.

[137]The European Union has agreed upon a minimum main rate of 15 percent, and rates vary from that to 25 percent in Europe. EC Sixth VAT Directive, *supra* note 3, art. 12(3)(a); OECD, Consumption Tax Trends 16 (1995). Elsewhere, countries with very broad forms of VAT can afford lower rates (such as New Zealand, NZL GST § 8(1) (rate of 12.5 percent)), while states under fiscal pressure have had rates of 30 percent or above. Tait, *supra* note 2, at 40.

[138]"Zero rate" has become the usual English-language term, except in EU documents. It is used, for example by Tait, *supra* note 2, ch. 3, and Hussey & Lubick, *supra* note 13, § 222; and in IRL VAT second sched. NZL GST § 11; ZAF VAT § 11; GBR VAT § 30; KAZ TC arts. 62–66. (There is inconsistency in the use of the hyphen—both "zero rating" and "zero-rating" are found.) There is no direct French equivalent. The French CGI, art. 261, addresses *opérations exonérées*, and this term is followed in the Swiss law. *See* CHE OTVA art. 15.

entitled to claim any input tax incurred in making that supply and is therefore entitled to a refund of that input tax if there is no output tax against which to offset the input tax.

The zero rate is sometimes known as exemption with credit.[139] Both terms are correct, depending on the approach taken to exemption and the structure of the tax. From one point of view, a tax rate of 0 percent is nonsense. It is not a rate of tax, and no tax is collected. A zero rate is therefore an exemption of the supply from output tax. A contrary argument is that in taxes with progressive rate schedules, a zero rate of tax is commonly found at the bottom bracket, so this is not a contradictory concept. It certainly works mathematically. The effect of a zero rate is approximately the same as that of a very low positive rate of tax. In any event, a zero rate does make the supply "taxable" in a technical sense and therefore achieves the objective of bringing these transactions within the operation of the VAT credit for input tax, which an exemption does not. This is because a VAT credit is allowed only for inputs to be used in making taxable supplies. For this reason, those who do not accept the existence of the zero rate recognize the right to the credit for input tax by saying that these supplies are "exempt with credit." There are arguments in favor of both approaches, and the present writer will readily confess to regarding both as entirely proper ways of defining the process. The question is one of terminology, and the appropriate solution may depend on the language and practice of a particular state.

D. Zero Rating Exports and International Supplies

Why do states have a zero rate? Its main use is to deal with exports of goods and exported supplies of international services. The destination principle calls not only for removing a direct charge to VAT from exports and international services, but also for removing any VAT indirectly imposed on those supplies in the form of input tax paid by a supplier. Only if the input tax is rebated will the goods leave the state free of VAT. The arguments about zero rating exports are also sometimes applied to supplies to diplomats, which are typically zero rated. The justification is that embassies are to be regarded as outside the tax territory of the state.[140]

Another specific service that is often zero rated is the supply of international transport.[141] The zero rating is usually widely drawn to cover both the supply of the services themselves and also supporting supplies of goods and services

[139]Technically, in EU law, the requirement is that states exempt the supplies that are discussed here as zero rated. *See* EC Sixth VAT Directive, *supra* note 3, arts. 15–16. However, a separate provision grants a right of deduction for input tax. *Id.* art. 17. This has the same effect as zero rating. It is the form followed in most EU countries and elsewhere in Europe, for instance in Bulgaria. BGR VAT arts. 7–12.

[140]*See supra* sec. V(E) (discussing the exemption of diplomatic activities).

[141]This applies throughout the European Union and elsewhere in Europe. EC Sixth VAT Directive, *supra* note 3, art. 15. It is easier for island states, such as New Zealand, to avoid this problem because the competition is less severe.

(e.g., selling provisions to shipping or repairing an aircraft). This is often done to protect international transport businesses based in the state from uneven competition from other states.[142] For example, two companies, one based in state A and the other in state B, supply bus services between cities in state A and state B. If state A zero rates the transport supplies, and state B does not, there will be a strong inducement for passengers to travel with state A's company. In addition, if tickets for the state B company are sold in state A, they may also be zero rated. An alternative approach of taxing the services in state B, but not beyond B's frontier, might be theoretically attractive but will pose practical difficulties. Some states have adopted the alternative approach of imposing a separate excise tax on the tickets provided for international transportation.

Coordinating rules will be needed to deal with supplies that fall under both exemption and zero rating. For example, if medical supplies are generally exempt, what about an export of medical supplies? Such an export should be treated the same as exports generally, for example, by excluding from the category of exempt transactions those that fall under zero rating.

E. Should Internal Supplies Be Zero Rated?

A few states zero rate some internal supplies. This is widely viewed as inappropriate, because it amounts to a subsidy of the activity or transaction treated in this way. It would usually be better to identify the policy reason for the subsidy and address it through a direct subsidy.[143]

A few special cases exist where zero rating may be justified on internal supplies, notwithstanding the above point. One case is of monetary supplies made to the national bank of the state. Failure to protect the national bank from a charge to VAT on all supplies of gold to it may result in taxing the national reserves. Similarly, it is normally regarded as appropriate to protect supplies of the currency itself to the central bank from the imposition of VAT. This will have to be done in any event in some way, and the simplest way is through zero rating. Other financial supplies are of course likely to be exempt.

Another special case is that of the sale or other transfer of an ongoing business. The problem arises when a taxable person transfers a business activity to another taxable person. Strictly, the seller must treat the sale of the business as subject to VAT (usually at the main rate). The buyer must therefore pay,

[142]It also avoids problems for some states that have goods transiting across them between third states. The transport service is supplied in the state, but none of the parties involved need have any contact with it (save for the presence of the vehicle and cargo during transit).

[143]As discussed in sec. V(G) *supra*, there are similar problems with using exemptions. If it is determined to provide a VAT preference rather than a direct subsidy, the question arises whether the preference should take the form of exemption or of zero rating. The latter is more costly in terms of revenue. It can also be unwise as a political matter, because it would open the door for arguments to zero rate other internal supplies. Zero rating also leads to administrative problems, in that a supplier may claim that a greater portion of its activities is zero rated than is in fact the case. On the other hand, one aspect of zero rating is more consistent with the structure of the VAT: unlike exemptions, zero rating does not provide an incentive for suppliers to avoid input tax. *See supra* sec. V(G).

along with the purchase price, the VAT on that price. If the purchaser is also a taxable person in respect of that business, then the purchaser can claim back the whole of the VAT paid as a credit for input tax. However, the associated credit or refund may take some time to receive, depending on the rules in the state dealing with large rebates of input tax. There are therefore significant potential cash-flow problems for the purchaser even though, in the long run, the input tax can be recovered. For the tax authorities, the sale of an ongoing business presents no problem. The VAT is accounted for from the business before and after the sale in the same way. In the long run, therefore, the sale will involve no additional VAT or loss of VAT.

To avoid this short-term problem, and recognizing that in the long run there is no revenue significance in this kind of sale, some states provide that such sales or transfers are zero rated. This means that the transaction remains taxable and does not distort any claims for input tax by the seller. Other states remove the transaction by taking it outside the scope of VAT, but in this case an adjustment may need to be made to deal with the problem of input tax.[144]

F. Paying VAT to the Tax Authorities

The law must establish a mechanism for each taxable person to account for the VAT collected by that person on sales, and to pay this tax over to the tax authorities at regular intervals, after deduction of any allowable input tax. The procedures for doing this are noted briefly in the next section. The element of substantive law involved is the right to claim a deduction for input tax.

G. Entitlement to Credit for Input Tax[145]

It follows from the definition of "value added" on which VAT is based that any VAT incurred by a taxable person as input tax should be repaid to that person in some way. The usual method of repayment is to allow the input

[144]If a sale or other transfer of an ongoing business is taken outside the scope of VAT, then it must be provided that the business is treated as continuing regardless of the change of owner to prevent a break in the flow of output tax and claims for input tax and also to prevent any claims by the new owner for input tax already credited to the former owner.

[145]Here again, there is inconsistent terminology in different VAT laws. The use of "output tax" (meaning the VAT imposed by the supplier on taxable supplies made by the supplier) and "input tax" (meaning VAT paid by the supplier) is now widespread in English-speaking countries, but it is by no means universal. The terms are used by Tait, *supra* note 2, but not in Hussey & Lubick, *supra* note 13, which uses the term "input credit." *Id.* § 231. "Input tax" is a defined term in the laws of New Zealand, NZL GST § 2(1); South Africa, ZAF VAT § 1(xxix); and the United Kingdom, GBR VAT § 24, but is not found in the EC Sixth VAT Directive, *supra* note 3, which focuses on tax for which the right of deduction has arisen. *Id.* arts. 17–18. The Swiss law refers to a right of deduction for the "previous tax" (*impôt préalable*). *See* CHE OTVA art. 29. The French law is not as consistent, referring to a deduction for the VAT "imposed on the elements of the price of a taxable operation," *see* FRA CGI art. 271, and in another place to a "deduction for the tax imposed on the goods or services which are not used exclusively for the realisation of taxable operations." *See* FRA CGI art. 273. The lack of a precise term in the statute is perhaps due to the fact that the operative rules for input tax are left to regulations. *See id.* The term in the German law is *Vorsteuer*, which could be translated as advance tax. *See* DEU UStG §15.

tax to be set off as a deduction or credit[146] against output tax collected during the same period. A duty is imposed on the taxable person to pay only the net amount to the tax authorities. In principle, therefore, all relevant input tax incurred by a taxable person should be available for credit in this way.

While the mechanism for crediting input tax presents few difficulties for taxable persons who make only taxable supplies (or exempt supplies that carry a right of credit), two sets of problems arise in particular cases. The first is that of the person who makes both taxable supplies and other supplies (either exempt supplies or supplies outside the scope of VAT). The second is the need to safeguard the award of input tax credit against fraud and transactions that may cause revenue loss to the state by avoidance or evasion. In addition, many states have, partly to deal with the second problem, made provision in the law disallowing credit for some kinds of input tax. Further, credit of input tax on capital goods is sometimes limited and spread over a period of years. Both sets of problems are discussed below.

H. Partial Exemption

The main category of taxable persons with problems in identifying the amounts of input tax available for credit is businesses that make some taxable supplies and some exempt supplies. These are often termed cases of partial exemption. The problem is the same for those that make supplies outside the scope of the tax. If a state has many exemptions from VAT, or has a limited base for the tax, these problems will be common. If a state exempts goods of a kind available for retail purchase, then a shop or business that sells these goods and other goods will be partially exempt. Most states exempt financial services; consequently, banks and other suppliers of financial services routinely confront the problems of partial exemption. For example, a finance house makes supplies of financial services, which are exempt, and also supplies business advice that is subject to VAT at the main rate. The finance house is a heavy user of telephones and incurs a substantial amount of VAT on its telephone bills. If the finance house were allowed to claim all the input tax on its telephone bills, it would be receiving excessive input tax. The law therefore allows the finance house to claim the VAT on the telephone bills that relate to its business advice services but not to its financial services. How is this to be handled?

[146]Again, there is inconsistent use of terminology about whether the input tax is available for deduction or credit. We have noted that the EU laws refer to a right of deduction. EC Sixth VAT Directive, *supra* note 3, arts. 17–18. The alternative form is to refer to a "tax credit" or "VAT credit." The latter term is, in the view of this writer, slightly preferable because it emphasizes that the input tax may exceed the output tax (and, at the extreme, that there may be input tax when there is no output tax), so that the "deduction" exceeds the sum from which it is deducted. This gives rise to an excess deduction or, better, an excess credit. It also helps to emphasize that there should be a credit (or deduction) for all VAT incurred by the supplier for business purposes. Direct tax laws impose strict controls on deductions, and such thinking sometimes erroneously strays into VAT laws.

The law must limit the right to claim a credit so that it covers only input tax incurred for the purposes of making taxable supplies. This requires a careful review of the total input tax paid by a partially exempt taxable person to separate out that input tax that is to be allowed and that which is not. There is no quick but entirely accurate way of doing this. The principles are that input tax incurred only for the purpose of making taxable supplies is allowed, but input tax incurred only for some other purpose or purposes should not be allowed. Input tax incurred partly for the purpose of making taxable supplies and partly for other purposes should be apportioned so that only the part devoted to making taxable supplies is available for credit.

There are significant practical problems in attempting to divide each item of input tax in this way, and a variety of solutions have been adopted in practice, such as averaging or estimating or generalizing from a partial audit of input tax. For example, the rules may be applied strictly for a trial period. During this period, the taxable person is required to identify any input tax paid on supplies acquired solely for the purpose of making taxable supplies, any input tax paid in connection with making supplies that are exempt, and the input tax to be apportioned. The input tax is apportioned in proportion to the total of taxable supplies and the total of exempt supplies (and, depending on how the law is structured, supplies outside the scope of the tax). This produces an overall ratio of taxable supplies to total supplies that might be, say, 40 percent. In the following year, unless either the tax administration or the taxpayer dissents, the same ratio of 40 percent can be used for allowing input tax without asking the taxable person to keep the same detailed records.

I. Disallowed Input Tax

It is increasingly common practice for states to deny input tax credits for certain kinds of supply. The main group may be described as supplies of or for luxuries, amusement, or entertainment. The precise application of a rule such as this will involve careful definitions. For example, supplies of "luxuries" to a luxury business cannot be disallowed fairly if the business is thereby prevented from recovering input tax on goods it buys in order to sell. By contrast, expenditure on business entertainment, such as a lavish meal for members of the staff of the taxable person, may more readily be disallowed. The justification is that these forms of input are always personal consumption. In effect, there is considered to be a deemed supply to the person benefiting from the expenditure. Denial of the input credit is an administratively simple mechanism for dealing with this deemed supply. There will also always be marginal cases, such as the claim that a racehorse or a yacht bearing the name of the taxable person's products is not a luxury or that a particularly expensive item is bought for the business and not for the benefit of those who own the business.

In some states, all credit for input tax on cars is disallowed, sometimes with exceptions, such as for taxis and rental cars.[147] Input tax on vans or trucks is allowed. Many states already have rules for income tax and other purposes distinguishing between cars and vans, and they can also be used for this purpose.

J. Capital Goods

For revenue protection reasons, some states have rules that require input tax on capital goods, or certain kinds of capital goods,[148] to be set off over a period of years in much the same way as the deduction of capital expenditure is controlled by capital allowances or depreciation for income tax purposes.[149] These rules are exceptions to the principle that, in general, no distinction is made for VAT purposes between revenue transactions and supplies and capital transactions and supplies. As such, rules identifying capital goods and applying limitations on credit of input tax are a breach of the fundamental principles underlying VAT because they prevent—or, rather, delay—the credit of all relevant input tax. As delay imposes cost, these rules create a distortion.

K. Safeguarding the Revenue

Claims for input tax credits are an inherent part of VAT, which is a tax on differences. Any attempt to curb input tax credit is therefore wrong in principle because it changes the way VAT operates from a tax on value added to a tax on gross sales prices. States are entitled to protect the revenue base of the VAT against abuse of the credit procedure in order to ensure that improper claims for input tax are not made. A major threat to the integrity of the reve-

[147]The EC Sixth VAT Directive, *supra* note 3, art. 17(6), provides that "VAT shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainments" and provides a procedure for agreeing on these disallowances. However, member states have failed to agree on a common set of rules for such deductions, and the article allows existing national disallowances to continue in force. The disallowance on cars applies in Denmark, France, Portugal, and the United Kingdom, and with exceptions in Greece, Ireland, Italy, and Spain. *See* Tolley's VAT in Europe, ch. 7 (1995). If a credit is denied for cars, it will generally be appropriate to exclude from the denial cars that are used for rental or that are held for resale.

[148]This approach was carried into the VAT in Russia and some other states of the former Soviet Union from the previous turnover tax under which expenditure on equipment did not qualify as a deduction against the sales tax payable. The EC Sixth VAT Directive, *supra* note 3, provides for adjustments for input tax credits to spread the credits on equipment over five years and on immovable property over ten years, although member states have the right to disapply the rules. *Id.* arts. 19–20.

[149]If such rules are adopted, the law must address the same issues, including the distinction between capital and revenue items, as under the income tax. *See* vol. 2, ch. 17.

nue base exists where input tax exceeds output tax and a claim is made for a refund to the taxable person of the amount of the excess. In a perfect VAT system, all such claims should be allowed within the normal time scale for paying the tax. However, some states have encountered widespread fraud in the operation of this practice, making safeguards necessary. Some can be linked specifically with the payment of a refund. The state should ensure that the rules dealing with input tax credits are clear and effective so as to prevent any doubt as to the extent of entitlement. This should also make it easier to check claims and audit taxable persons making claims.

L. Bad Debts

The rules suggested in this chapter are designed to ensure timely payment of the VAT related to a supply. Under these rules, occasions would frequently arise when the VAT has been paid on a supply to the tax authorities, but payment for the supply is not received until a later time. In the extreme cases, more common in economies in transition, some or all of the payment will not be received at all, because the customer becomes insolvent or in some other way the debt becomes bad.

Payment of VAT to the tax authorities ahead of receipt of the VAT from the customer is a normal aspect of a VAT. This may provide a cash-flow disadvantage to the taxable person. In many states, this disadvantage is not particularly significant because the taxable person benefits from a much greater cash-flow advantage that arises from holding VAT collected from some customers for several weeks before having to pay it to the tax authorities. In addition, the supplier may recover some of the economic cost of the delay in payment through an interest charge on the sums outstanding. Where this happens, the interest charge is not subject to VAT. In addition, where the customer is a taxable person and receives an input credit for the VAT on the transaction, the customer could use the cash saved by the input credit to pay the supplier at least the amount of VAT. The parties are always free to make such an arrangement as part of the terms of their sales agreement. If they do not make such an arrangement, then the seller is in effect extending a credit to the purchaser above and beyond the cost of the goods.

Bad debts may be seen as presenting a different problem. It is no longer one of cash flow, but of ensuring that the tax remains a tax on value added. If payment is not received by a supplier, then the supply may result in a loss to the supplier, with no value added. A distinction may be drawn between the case of the very slow payer and the person who cannot pay. A solution to the problem of nonpayments, as opposed to late payments, may entail a specific allowance for bad debts.[150] This allowance will amount, in effect, to the equiv-

[150] *E.g.*, GBR VAT § 36.

alent of input tax to offset any output tax paid to the tax authorities but not collected from the customer.

If this approach is followed, a definition of "bad debt" is needed to ensure that any allowance for a bad debt does not encourage slow payment. For this reason, it is important that the mere fact of nonpayment should not make the debt bad. It should be shown that the debt is not collectible with reasonable effort on the part of the supplier, and that a minimum set time has elapsed. The length of that period will depend in part on the business practice of a state and on its economy. Inflationary factors are clearly relevant, as is the usual practice for payment of bills. Where all bills are long delayed before being settled, the period for this provision will need to be longer.

While it is typical to provide an allowance for bad debts, there is a counterargument. On the assumption that finance charges are set at a level adequate to compensate for bad debts, the total group of borrowers bears the burden of bad debts through the interest payments they make. The cost of the consumption by defaulting customers is therefore borne by other borrowers. But because interest is not subject to VAT, there would be an understatement of the overall tax base if the amount of bad debts were subtracted from the base, in addition to excluding interest. The difficulty in deciding on an appropriate policy for bad debts is that not all bad debts are covered by finance charges. Instead, suppliers may take the risk of bad debts into account in setting prices for all. On this assumption, it would be appropriate to provide an allowance for bad debts. In the case of bad debts owed by customers who are themselves taxable persons, however, a bad debt allowance would not be necessary. If an allowance for bad debts is made, there should also be a reversal of the customer's input credit, leading to a wash. The conclusion is that the case for a bad debt allowance is not as obvious under the VAT as it is under the income tax, and that under certain assumptions such an allowance would not be needed.

VIII. Procedure and Administration

A. Need for Specific VAT Rules

Legislative approaches to dealing with administrative and procedural provisions of tax laws vary markedly from state to state. It is therefore difficult to provide any general form of provision for the procedure that must be associated with the collection of VAT by taxable persons or for the administration of VAT by the tax authorities.

In general, there are distinct advantages to combining, as far as possible, the procedure and administration of VAT with that of other taxes. If this is done, then the matter can be dealt with in common laws dealing with taxes generally and with compatible procedures. This is more efficient for the administration and easier for taxpayers to understand.

B. Combining VAT and Customs Administration on Imports

The case for combining the collection of VAT on imports of goods with the collection of customs duties is particularly strong. Questions of procedure for handling VAT on imports should as far as possible follow the procedures followed for customs duty purposes, just as this chapter has assumed that the substantive law follows customs duty law. Similarly, there is a clear case for giving the duty of collecting VAT on imports to customs officials. For that reason, the relevant administrative provisions should be aligned to customs laws. The simplest form of provision is one that treats VAT on the import of goods as a customs duty for all purposes of administration of VAT. This would mean that customs officials can use the same powers to enforce VAT on imports as they have to deal with customs duty. This approach will ensure that powerful provisions exist to handle VAT on imports with a minimum of legal difficulty, administrative provision, and taxpayer confusion.

C. Handling VAT on Internal Supplies

There is also a strong argument for combining the administration of VAT on internal supplies with the administration of the direct taxes. In particular, many income tax payers with business income will also be taxable persons for VAT purposes. Many transactions will require review for both income tax and VAT purposes, although the ways in which income tax and VAT liabilities are calculated from that common base are radically different.

Despite the differences in result, many of the problems of administration of direct taxes and VAT invite similar solutions. For example, the powers of auditors carrying out field audits, or those of desk officers demanding information from taxpayers or from third parties may be aligned. There is an additional advantage in aligning these powers in that officers will be able to gather information for the two kinds of tax liability at the same time, thereby minimizing the demands on taxpayers. This approach also enables a cross-check on compliance with the requirements of one tax from information gathered in checking compliance with the other. One of the strengths of the invoice-based form of VAT is the resulting audit trail, which can be used to check other taxes.

In the light of these general remarks, this chapter discusses only those areas of administration and procedure that are peculiar to VAT. It is assumed that for other matters the state will have separate legislation dealing with tax administration or that the rules in the VAT law will parallel those in other tax laws.

D. Regulations, Instructions, and Guidance

The VAT is an invasive tax and potentially applies to every aspect of the economy. It is impossible to set out in one law all the rules, regulations, proce-

dures, and working practices necessary to ensure the smooth operation of a tax that can apply to several million transactions a day in a state. Not only does the VAT have this invasive, and pervasive, effect, but it must also take a clear enough form so that all those charged with settling transactions and issuing VAT invoices can do so with confidence and without delay. The laws, rules, and guidance must be effective, and the legislation is no more than the highest level of a multilayered system of providing rules and procedures.[151]

E. VAT Invoices

A VAT invoice is an invoice, chit, till roll print, or other document[152] that is issued by a taxable person who makes a taxable supply and that records the supply and the amount of VAT payable on it. In an invoice-based VAT system, as described in this chapter, the issue of invoices in the proper form is an essential part of the procedure for imposing and enforcing the VAT. The requirement that a special invoice be issued is a feature unique to VAT.

An invoice is a "VAT invoice" if it complies with the requirement of the VAT law. Invoices issued for other purposes or that do not comply with these requirements do not count as VAT invoices.

VAT laws typically condition the allowance of a credit for input tax on the existence of a VAT invoice issued during the period for which the credit is claimed. An invoice is also required by the tax authorities to audit the collection of VAT. To allow these requirements to be met, the law should require a supplier making a taxable supply to another taxable person to provide a VAT invoice with that supply or the payment for it. The requirement should be enforceable by some penalty or procedure. The law could further specify that the purchaser's copy of the invoice, once created, is the property of the tax authorities, and not of the supplier or the purchaser.[153]

The timing rules noted previously[154] are linked to the time of issue of a VAT invoice. For that reason, together with the reasons noted in this paragraph, the supplier is usually required to issue the VAT invoice at the same time as, or soon after, the supply. For example, the law might require the supplier to issue a VAT invoice no more than seven days after the delivery of goods or payment for those goods. This type of short time delay ensures that an invoice in respect of a transaction, say, at the end of the last working day of a week can be legally issued at the beginning of the following week.

[151] *See supra* ch. 2, sec. IV; ch. 3, sec. IV(D).

[152] There is a strong case for providing in regulations for paper records to be substituted by electronic records in some cases, provided that the requirements of evidence for effective auditing are also met.

[153] This would impose a duty on the person holding the invoice to preserve it and produce it on demand.

[154] *See supra* sec. III(H).

A VAT invoice is normally required to be identified as such (perhaps by having the words "VAT invoice" on it) and to contain a minimum of information about the supply being invoiced. That information would normally include[155]

- the name, address, and VAT number of the taxable person making the supply,
- the nature of the supply made (type of supply, type of goods or services, and quantity of goods or extent of services),
- the time the supply was made,
- the amount of payment for the supply,
- the amount of VAT,
- the name, address, and VAT number of the taxable person supplied,
- the date on which the invoice is issued, and
- the serial number of the invoice (together with identification of the printer if the invoice was purchased privately).

A state may not need to include all this information. For example, if there is only one rate of VAT, then it is redundant to state both the amount of VAT and the amount of payment for the supply. The redundancy may, however, be considered appropriate in light of the fact that taxpayers can make computational mistakes, particularly if both exempt and taxable sales are shown on the same invoice.

The requirement to include all this information will make a VAT invoice a formal document. This will not be appropriate for small transactions, for example, those made by a retail store, particularly where the customer is not a taxable person. States frequently allow special simplified invoices for small transactions or for transactions recorded in a retail store in a till or cash register. For example, in these cases, it will not be required that the details of the customer be recorded unless, perhaps, the customer wishes it. For the sake of clarity, the law should distinguish between the formal VAT invoice[156] and simplified invoices. Only the VAT invoice will entitle the purchaser to a credit for the VAT shown on the invoice, and special procedures will apply to the VAT invoice that do not apply to simplified invoices. While the basic distinction should be drawn in the law, matters such as acceptable forms for simplified invoices are best dealt with by regulation and guidance.

It will make for efficient administration if the tax authorities produce examples of the forms of VAT invoices acceptable to them that comply with the law. However, it is better that this level of detail be omitted from the main legislation. Flexibility should be provided, for example, to allow computer-issued invoices.

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[155] *See, e.g.*, The Value Added Tax (General) Regulations 1985, art. 13, *reprinted in* Butterworths VAT Handbook 1995, at 465.

[156] This is typically known as a "tax invoice."

F. VAT Returns

The other document essential to administering a VAT is the required provision of information at regular intervals by all taxable persons. This provision of information and the document on which the information is provided is commonly known in English as a "return." There should be a standard form of return, so that taxable persons know precisely what is required of them and can comply more easily with the formalities of making a return, and so that the tax administration can process returns efficiently.

All taxable persons should be required to make a return of their taxable transactions and other relevant information at predetermined and regular intervals. These intervals are called "VAT periods."[157]

The return should cover all taxable transactions made by the taxable person during the VAT period and should show how much VAT is payable to the tax authorities for that period.

The essential information on a return is therefore the following:

- the total VAT collected on all taxable supplies made by the taxable person (output tax) in the VAT period,
- the total VAT paid by the taxable person on supplies made to the taxable person in the VAT period and for which a credit is allowed (the allowable VAT credit or input tax deduction),
- the amount of any bad debts to be set off against output tax in that VAT period, and
- the amount of any excess of allowable input tax over output tax in the previous VAT period that can be carried forward (allowable excess VAT credit or input tax deduction).

The requirement that a return be made for each VAT period needs to be enforceable, with a reasonably strict time limit for submission, such as within 15 days of the last day of the VAT period to which the return relates. A return should be required even if the taxable person has no taxable supplies for a VAT period. This rule allows efficient operation of systems to detect and chase after persons who are delinquent in filing.

G. Payment of VAT

The law should also specify that all taxable persons must pay to the tax authorities at a specified time the net amount of VAT due for the VAT period (i.e., all VAT collected (output tax) less allowable VAT credit (deduction for input tax) and any allowable excess VAT credit carryover and VAT with respect to bad debts).

[157]*See infra* sec. VIII(I).

The duty to pay is usually on a self-assessment basis (i.e., the taxpayer itself determines the amount due by filling out the return). Each taxable person is responsible for paying the VAT due to the tax authorities in respect of any VAT period at the same time as (or, if convenient, separately but before) the return for that period is due.

Some states require advance payments of VAT, for example, three times a month, based on VAT liability for previous periods.[158] The advance payments are then credited against the VAT due with the return.

H. Assessing VAT

Where a return has not been made by a taxable person (including persons not registered for VAT that should be registered or importers not covered by the import procedures) for a period for which a return should have been made, the tax authorities should be given reserve powers to impose an obligation on the taxable person to pay VAT to the tax authorities. For example, the tax authorities can be empowered to make a formal assessment[159] of the estimated amount of VAT that a taxable person or other person is believed to owe to the tax authorities in accordance with the law.

The tax authorities should also have the power to collect any other VAT, estimated amounts of VAT, or sums equivalent to VAT. This can deal, for example, with an unauthorized person issuing what purports to be a VAT invoice. The "VAT" collected by that person is due to the tax authorities, and the power to assess could provide the most convenient way of doing this.

The power to assess should also be available to deal with cases where the tax authorities have reason to believe that the returns made by a taxable person are not accurate and do not show the full amount of VAT due from that person. The tax administration law should deal with the formalities of making assessments and procedures for challenging them.

I. VAT Periods

The payment of VAT to the tax authorities is linked to a "VAT period" as explained previously. The length of a VAT period is a policy matter for the state. The standard period is the calendar month; often, taxable persons with small levels of taxable turnover are allowed to use longer periods of three months or a year.[160] The VAT period should be distinguished from payment periods.[161] Thus, for example, a state may require enterprises of a certain size

[158] *E.g.*, KAZ TC art. 72(1).

[159] The process is an inherent part of the income tax in most states, and it will be efficient to apply the same procedures used for the income tax, except for those that are not relevant to VAT.

[160] In economies with high levels of inflation, shorter periods may be appropriate. *See infra* ch. 13, sec. II.

[161] *See supra* sec. VIII(G).

to make advance payments of VAT three times a month, while the VAT period remains a calendar month.

J. Repayment of Excess VAT Credit

Where the input tax credit for any VAT period exceeds the output tax collected, there is an excess of VAT credit or of deductible input tax. As a direct result, the taxable person will pay no VAT to the tax authorities for that period. However, should the tax authorities pay the difference to the taxable person?

VAT is fundamentally different from direct taxes in that it involves regular situations where a taxable person is owed money from the tax authorities. This is an essential feature of VAT if it is truly a proportional tax based on regular VAT periods. The situation will arise, for example, where the taxable person buys expensive equipment or machinery costing more than the total of taxable supplies made by the taxable person during that VAT period. It also arises if the law makes provision for rebating tax to exporters.

Policymakers may be tempted to reduce or abolish the right for taxable persons to demand payments from the tax authorities, especially where state budgets are under pressure. There is an opposite temptation on political representatives to make the operation of VAT "fair" by imposing the same tight timetables on the tax authorities rebating VAT as on taxable persons paying it.

Both temptations can present major problems for the state and the tax authorities if the rules concerning VAT refunds are not carefully formulated and applied. A failure to allow any repayment of excess input tax undermines the fairness and economic neutrality of VAT collection. If applied to exporters and other similar taxable persons, it can harm the economic competitiveness of those persons and therefore of the state.

By contrast, a regime demanding early rebates of excess VAT credit or excess deductible input tax places a tax authority at a disadvantage in dealing with evasion and fraud. In particular, there is a danger that rebates will be given in situations where an input tax credit has been claimed for a supply but the supplier (or alleged supplier) of the supply (or alleged supply) has not paid an output tax to the tax authorities. There is also a danger of persons representing themselves as taxable persons when they are not, in order to claim input tax repayments when they have no intention of paying more than a nominal amount of output tax to the tax authorities. In the worst case, the so-called taxable person will simply disappear after receiving the credit, having made money from the tax authorities. There will also be cases where an expenditure that is not made for business purposes is said to be made for business purposes (e.g., on the purchase of a car or boat), so that an input tax repayment is made for input tax not paid out for business purposes.

Balancing these two pressures on a tax authority has proved problematic in a number of states. Repayments of excess VAT credit should be allowed, but with safeguards. One possible safeguard is to require the excess VAT credit to be carried forward for a specified period (e.g., six months) before a repayment can be claimed. Another safeguard for the revenue is a phasing of VAT credit on large expenditures through capital goods rules.

Further safeguards should empower the tax authorities to audit any claim for repayment before being required to make the repayment if there is reason for suspicion. For example, if the tax authorities are bound to make the repayment within a certain time, they should have the right to stop the time running if an audit is carried out. It is also important that the tax authorities have all the powers necessary to carry out these audits, and that they be seen to exercise those powers. The tax authorities should also have the power to assess taxable persons (or others) to recover excess repayments of excess input tax.

Another safeguard is to allow the tax authorities to require securities or guarantees (e.g., from a bank) to ensure that the taxable person continues making taxable supplies after the repayment is made or to make repayments only when subject to other conditions for the protection of the integrity of the revenue. Where the financial system allows, this may be a particularly convenient way of balancing the needs of the tax authority with the entitlements of larger taxpayers.

IX. Special Cases

The potential complexity of VAT when applied to every form of taxable supply has been mentioned. There will, in practice, be whole classes of supplies and of taxable persons where one or more of the general rules of VAT pose difficulties or uncertainties. Small businesses may find that some aspects of VAT procedure impose heavy burdens. Specific sectors of economic activity such as farmers may have difficulty conforming with the way the tax works. Auctioneers or other agents may have difficulty determining how VAT applies to their supplies. Problems may arise for them and for other kinds of agent in the supply of items between taxable persons and nontaxable persons. Taxable persons such as retailers may find it difficult to account to the tax authorities for the VAT on a large number of low-value supplies, particularly where only some of the customers are other taxable persons.

A detailed study of any fully developed VAT law will reveal a range of special rules derogating from the general framework in particular cases. These derogations are usually designed to make VAT workable. The law should make provision for these special rules to be created. This is probably best done in most states through regulation although, in some areas, it may

most effectively be done through agreement with trade organizations or after discussion with other government agencies. While these schemes should be the exception rather than the rule, some special provision is usually unavoidable.[162]

[162]The EC Sixth VAT Directive, *supra* note 3, makes provision for a number of special schemes, including for small undertakings, *id*. art. 24; a common flat-rate scheme for farmers, *id*. art. 25; for travel agents, *id*. art. 26; and for secondhand goods and works of art, *id*. art. 26a. The member states of the EU do not have common schemes for these special cases (except for secondhand goods, where a common approach was agreed upon in 1994, Directive 94/5 of February 14, 1994, 1994 O.J. (L 60) 16), nor have they all adopted the special schemes. Other special schemes are allowed by derogations, for example, fisheries (Belgium and Netherlands), oil and gas (France), and gold (United Kingdom). *See* the summary of national laws *in* Tolley's VAT in Europe, *supra* note 147. However, the approach of countries with a broad-based tax, such as New Zealand, is to avoid these schemes wherever possible.

7

VAT Treatment of Immovable Property

Sijbren Cnossen

Housing is one of the most difficult items to handle under a value-added tax.
—*Charles E. McLure, Jr.*

I. Introduction

The appropriate treatment of housing and housing services, as part of the wider area of immovable property, is probably one of the more complicated and, it seems, intractable issues in the theory and practice of the value-added tax (VAT). In most industrial countries, housing services, comprising rents and rental values of owner-occupied dwellings, constitute 15 percent or more of total annual consumption expenditures as computed for national accounts purposes. Surely, this is too large a portion to ignore under a broad-based VAT. Yet, conceptual difficulties and, above all, administrative and political problems seem to preclude the taxation of housing services in a satisfactory and evenhanded manner.

To understand the principles and approaches that are found in various countries, a brief review of some of the pertinent characteristics of the VAT provides some clues as to how immovable property should be taxed. Next, the actual VAT treatment of immovable property in the member states of the European Union (EU) and selected other countries that are members of the Organization for Economic Cooperation and Development (OECD) is surveyed. Finally, a concluding section evaluates this chapter's major findings.

II. Nature of the VAT

The VAT is an *in rem* tax on domestic consumption. The tax is of the *in rem* type because personal circumstances are left out of consideration, un-

Note: An earlier version of part of this chapter was published in 10 Tax Notes Int'l 1037 (1995).

like, for instance, under the income tax (or, for that matter, an expenditure tax). Although the tax is intended to be borne by the consumer, the consumer is not taxed directly. Instead, "taxable persons" are all producers and distributors who manufacture and trade in taxable goods and services. Each taxable person has to remit that part of the total tax, collected by the retailer from the final consumer, that equals the tax rate times the value added by that taxable person. To achieve this, the VAT is imposed upon "taxable events," that is, the delivery of taxable goods and services. Each time a commodity changes hands, tax is due and tax on inputs can be credited against tax on outputs. As a result, all commodities can in effect be traded tax free within the "ring" of registered businesses, but the full tax is payable once goods and services leave the ring, because they are sold to unregistered persons, usually consumers.[1]

There is wide agreement on the nature of the VAT collection mechanism. VAT is simply a retail sales tax that is collected piecemeal throughout the entire production-distribution process. The consensus may be smaller, however, on some of the theoretical underpinnings of the tax. Is the VAT a tax on consumption *activities* or, more narrowly, on consumption *expenditures*? Is the VAT a tax on *current* consumption or, more broadly, a tax on all commodities that leave the ring of registered businesses, regardless of whether they are consumed forthwith or embody a stock of services that are consumed over the useful life of the asset? Cars, household appliances, furniture, and, of course, houses are examples of the latter type of asset.

The answers to these questions seem pertinent to obtaining the right focus on the appropriate treatment of immovable property. To a large extent, the answers depend on whether one adopts a theoretical, economic point of view or whether one takes a more practical, legal approach to the VAT.

A. Activities or Expenditures?

From an economic point of view, ideally the VAT should tax all consumption activities because this approach would most closely satisfy commonly accepted equity and neutrality criteria. As a tax on consumption activities, the VAT should in principle include self-produced items of consumption, such as garden vegetables and household meals, in the base at market value. This would ensure equal treatment with other products bought in the marketplace. Proponents of this view draw a parallel with the accretion concept of income that, in theory, also includes in the base the value of self-

[1]For a discussion of the nature of the VAT, *see* Sijbren Cnossen, *The VAT and RST: A Comparison*, 35 Canadian Tax Journal 559 (1987). Sales in the ring are in effect tax free because, even though such sales are taxable, the tax paid is offset by a tax credit available to the purchaser. *See, e.g.*, CAN GST § 169. By contrast, under a sales tax with a ring system, such sales are exempt.

produced items.[2] Purists stretch the point even further by insisting that the consumption of leisure should be taxed as well.

To be sure, it is readily admitted that it would be impracticable to tax home-produced consumption (not to mention leisure), but, the argument goes, this should not detract from the principle. It is also pointed out that all VAT laws stipulate that goods withdrawn from the stock of a business for personal use are taxable. If a butcher takes meat from the larder for consumption at home, he or she has to pay tax on its market value, although the supplier's price is often taken as a close enough proxy (this means that, as an alternative, the tax credit attached to the purchase of the meat can simply be denied). Generally, the meat would also be taxable if it were "produced" by slaughtering a calf that had been fattened on the butcher's premises.

Under the legal approach to VAT, however, it is emphasized that even in principle the VAT is not intended to tax nonmarket consumption activities. If, in the example above, the butcher is taxed, it is because as a taxable person he or she supplies him- or herself with the meat, either directly from the larder or indirectly by raising the calf. In other words, the meat is not produced in a personal capacity, but in a business context. This triggers the taxable event. In contrast, the homegrown vegetables of the butcher would not be subject to the VAT. The definition of "taxable event" in VAT statutes emphasizes that only goods and services bought in the marketplace are taxable. Moreover, the VAT generally becomes due only if the taxable transactions are undertaken for a "consideration." Self-produced items of consumption and, for instance, gifts are not taxable. In short, the tax is on consumption *expenditures* rather than on consumption activities.

B. Flows or Stocks?

Is the VAT a tax on current consumption or simply a tax on consumption items that leave the ring of taxable persons? Most economists would insist that the VAT is a tax on flows, not on stocks.[3] Ideally, under the VAT, durable consumption goods, such as cars, that provide a flow of services over a long period of time (extending, say, beyond the normal tax reporting period) should not be taxed on their value at the time of purchase, but rather on the value of the services that the goods subsequently provide.

Again, it is admitted that it would be impracticable to implement this rule literally. Hence, as a second-best measure, it is assumed that the purchase

[2]*See, e.g.*, Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45, 79–83 (1990).

[3]This is the view found in Alan Schenk, *Value Added Tax: A Model Statute and Commentary: A Report of the Committee on Value Added Tax of the American Bar Association Section of Taxation* 72–79 (1989). For a strong defense of the VAT as a tax on consumption flows, *see also* Robert F. Conrad, *The VAT and Real Estate*, *in* Value Added Taxation in Developing Countries 95 (Malcolm Gillis et al. eds., 1990).

price of a durable consumption good represents the discounted present value of its future services. By extension, the tax on the purchase price may be considered a close proxy of the discounted present value of the tax that should have been levied on the flow of services. This "prepayment method" is also found in the literature on the personal expenditure tax.[4]

Lawyers and tax administrators point out that the foregoing view is a misrepresentation of the nature of the VAT. The VAT is not a personal tax, but an *in rem* tax on consumption expenditures. For all goods and services, a cutoff point must be established at which the tax becomes final. That point is the retail stage, regardless of the kind of commodity that is sold. The *in rem* nature of the VAT does not support the position that durable consumption goods should be treated differently from nondurable consumption goods. Neither in theory nor in design does the VAT permit imputing a current consumption value to durable goods. Ultimately, the VAT is a tax on consumption expenditures as they are incurred. Although the taxation of transactions may not be a goal in itself (as it would be under, say, a stamp duty), it is sufficiently central to the nature of the VAT that it cannot be ignored.

III. How Immovable Property Should Be Taxed

The previous discussion has an important bearing on the way in which immovable property should be treated under the VAT. Land and buildings embody stocks of services that can be used for consumption or production. If immovable property is used for production purposes, like plant and machinery, the services that it generates should not be taxed. Any tax paid at the time of purchase of the property should be creditable immediately against the tax on the sale of other property or the tax on the products made by, say, the factory situated on the property. If there is no tax on sales, simply because there are no sales, a refund would be due forthwith. On balance, no tax should attach to the factory, regardless of whether it was used or not.

A. An Economic Point of View

From an economic point of view, the same treatment should be accorded immovable property that generates housing services. The most attractive solution from a theoretical perspective would be to register for VAT purposes all persons, natural as well as juridical, who own or buy residential real estate. By purchasing a dwelling, these persons would become producers, not consumers, of housing services. In their role as producers, they would subsequently sell the housing services to consumers. Either these consumers might be third parties

[4]*See, e.g.*, Michael Graetz, *Implementing a Progressive Consumption Tax*, 92 Harv. L. Rev. 1575, 1597–623 (1979).

who buy the services against a consideration, that is, a rental charge, or each producer might sell the housing services to him- or herself as the owner-occupier of the dwelling.

The VAT consequences of these events are obvious. The registered taxpayer who buys a bundle of housing services in the form of a dwelling would pay tax on the purchase price, but at the same time the taxpayer would be entitled to a tax credit (and refund, if due) for the same amount. If the taxpayer sells the housing services to a third party, that is, a lessee, he or she would have to charge VAT on the amount of the rental. The lessee, being an unregistered consumer, would not be able to pass the tax on but would be stuck with it just like consumers of other commodities. Similarly, as owner-occupier, the producer of housing services would charge VAT on these services, represented by the rental value of the dwelling, rendered to him- or herself as consumer. And like the lessor, the producer would have to remit that tax (net of any tax on inputs, such as repair and maintenance services) to the tax office.

So far the discussion has been about buildings, but the treatment of land would not be any different. If land generates production services, it should follow the same treatment as the factory above. If it is a producer good that generates consumption services (because it is used for hunting hares or simply to sit on), then the same reasoning holds as given above in respect of housing services. Feasibility considerations may dictate other solutions, but it is simply nonsense to say that land should be left out of the base because it is not a consumption good. The issue is whether land generates consumption services.

B. A Legal Point of View

Those who take a legal point of view, as outlined in section II above, do not subscribe to the characteristics of the VAT as a tax on flows. For them, the VAT is a tax on transactions designed in such a way that, ultimately, only consumption expenditures are taxed. In their opinion, immovable property should be taxed if and when it is transferred from the production or business circuit to the consumption or consumer circuit. Thus, newly constructed buildings, residential as well as other real estate, should be taxed at the time they are completed. If the buildings are subsequently rented out for business use or residential use, the rents should be taxed and the tax on the purchase should be creditable against the tax on rents. If residential property were sold to an owner-occupier, however, the tax on the sale would be considered final. The notion that this tax represents the capitalized value of the tax on the value of all future housing services is a useful, but not essential, rationale for this approach.

Furthermore, it is pointed out that, in practice, the registration of all owner-occupiers, as well as the computation of all rental values, would present formidable administrative problems that a VAT should not take on. Most countries do not tax the rental value of owner-occupied property under their

income tax or do so at reduced values. Politically, taxing rental values under the VAT would be even harder to accomplish. It would be difficult to explain to owner-occupiers that taxing the rental value of their dwelling under the income tax as well as under the VAT would not constitute double taxation. Under the income tax, owner-occupiers enjoy the rental value in their role as investors, whereas under the VAT they would enjoy the rental value in their role as consumers. Finally, most nonresidential property is located in the agricultural and industrial sectors or is owned by the government. Taxing such property would not yield any net revenue.

Admittedly, taxing rents but not rental values appears to favor owner-occupiers over lessees who would pay the VAT on rental charges. To achieve approximately equal treatment, moreover, it would be necessary to levy the VAT on the sale of owner-occupied dwellings, because the sale of a dwelling from a (taxable) lessor to an owner-occupier would also be taxable. The tax on the original purchase would then have to be taken into account as well as the tax paid in respect of repair, maintenance, and other costs. Complications would arise if dwellings that were initially occupied by the owner were subsequently rented out or if rental property subsequently became owner occupied.

In the legal view, therefore, the best alternative is to tax new residential construction and then to forget about it. In other words, lessors would also be treated as exempt persons. They would pay tax on purchases of new housing, but would not be able to charge the VAT on rental charges, take credit for tax on purchases of new fixtures, appliances, maintenance costs, and so on. Levying a final tax on new residential construction might leave some distortions in the consumer market for housing services, but few in the market of producers of housing services. The treatment would not discriminate against other services or against services involving the maintenance or renovation of the existing housing stock, assuming that these services are taxed in full along with building materials, fixtures, and whatever else goes into a house to make it habitable. The tax on new residential construction would favor the owners of the housing stock in existence at the time the VAT is introduced, but this advantage would diminish over time.[5]

If current housing services are to be left out of the base, what about current commercial building services, assuming that new commercial buildings are to be taxed? For the most appropriate VAT solution, the use that may be made of these buildings must be taken into account. Commercial buildings, that is, buildings that are used for production purposes, may comprise factory buildings that are difficult to convert to other uses, but also office buildings that may be used either by a registered manufacturer or trader or by an exempt entity such as a bank or nonprofit organization. Moreover, some office build-

[5]The extent of this advantage depends on what tax the VAT replaces. If it replaces a turnover tax that covered construction goods and services, then the existing housing stock may be largely tax paid.

ings can be converted into apartment complexes without much ado and vice versa.

C. Practical Solutions

Two approaches, largely identical in result, are used to resolve the issue. Under the tax method, found in Canada and New Zealand, the sale and rental of immovable property are taxable in principle, but residential rents (and rental values) are exempt,[6] as is the sale of previously occupied residential property.[7] This implies that the construction, alteration, and maintenance of all buildings are taxable. So is the rental of business accommodations. Also, sales of existing buildings are taxable, unless such buildings constitute residential property. The definition of "previously occupied" should be tailored to the mechanics of the tax in the particular country. For example, in Canada, the exemption applies to the sale of a residential complex by the individual who built the complex and who occupied it as a place of residence, unless the individual claimed an input tax credit in respect of the acquisition of the real property included in the complex. Also exempt is a sale of a residential complex by a person who is not a builder of the complex, unless the person claimed an input tax credit in respect of the acquisition of the complex.

Under the exemption method, prescribed in the Sixth Directive of the EU, in principle the sale and rental of immovable property are exempt,[8] but newly constructed buildings as well as alterations and maintenance of the existing building stock are taxable.[9] Unlike the tax method, which requires a definition of residential use, the exemption method needs a definition of specified nonresidential use, such as hotel accommodation, camping facilities, and parking space, which are taxable. Furthermore, because the commercial use and sale of existing immovable property are also exempt, the opportunity of optional registration must be provided to avoid potential discrimination and cumulation of tax.

Both approaches must address the VAT implications of the supply of land. Unimproved land is traded less often than buildings are and is used more often for productive purposes in exempt sectors, such as agriculture. New Zealand exempts all land, improved as well as unimproved. Under the Sixth Directive, however, unimproved land is exempt, but improved land, including land on which buildings are sited, is taxable. Probably, the difference in treatment reflects the difference in the relative scarcity of unimproved land. In New Zealand, the "land element" of the purchase price of a building must be

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[6]CAN GST sched. V, pt. I § 6; NZL GST § 14(c), (ca).

[7]CAN GST sched. V, pt. I §§ 2, 3; NZL GST § 14(d).

[8]*See* Sixth Council Directive 77/388, art. 13B(b), (g), (h), 1977 O.J. No. L 145/1.

[9]*See id.* art. 4(3).

separated out from the total consideration. Under the Sixth Directive, the land element must be separated out from the value of other (unimproved) land that is part of the same parcel.

Under both approaches, sales of existing housing stock are exempt. Thus, the introduction of a VAT that raises housing prices provides a windfall gain for the owners of the existing housing stock. This effect can be mitigated by taxing the initial sale of all dwellings following the introduction of the VAT.[10] Although feasible, no doubt such a novel extension of the VAT base would be strongly resisted. The existing housing stock would have to be valued at that time. Moreover, owners of the existing housing stock would have to retain all invoices of alterations and maintenance expenditures showing VAT that would be creditable against the VAT on first sale at some future date. These invoices would become more difficult to verify with the passage of time. No country has adopted this approach upon the introduction of the VAT.

IV. How Immovable Property Is Taxed

Table 1 shows the treatment of immovable property in the member states of the EU and some other OECD countries with VATs. For expository purposes, it seems useful to distinguish construction activities from the lease and sale of immovable property. In several countries, property transfer taxes, such as registration duties, imposed on gross selling prices interact with the VAT; when the VAT is levied, the transfer tax is not imposed, and vice versa. Hence, these taxes are also shown.[11]

A. Construction

The consistent VAT treatment of various construction activities, such as the sale of building materials, the rendering of repair and maintenance services, and the creation of new buildings, is essential if distortions and administrative difficulties are to be avoided. As indicated in Table 1, nearly all countries tax building materials at the standard rate. Exceptionally, Ireland applies the lower rate of 12.5 percent to concrete, and Italy taxes "raw materials and semifinished products for the building industry" at 9 percent. In most countries, the treatment of repair and maintenance services follows that of building materials. Exceptions are found in Belgium, which taxes construction services (and, by extension, building materials) in connection with dwellings that have been occupied for at least 20 years at the lower rate; in Ireland, which taxes repair and maintenance services at

[10] *See* Alan A. Tait, Value-Added Tax: International Practice and Problems 83 (1988).

[11] For a summary review, *see also* OECD, Taxing Consumption 183–86 (1988).

12.5 percent;[12] and in Italy, which favors work on old buildings (of which it has many) by taxing it at 4 percent. These end-use types of exemptions must be difficult to monitor properly.

Logically, building materials and repair and maintenance services (broadly interpreted as construction services) add up to a new building. Most countries realize this; under their VATs, the treatment of newly constructed buildings is the same as that of materials and labor. If the rate on new buildings were different, the effective rate on materials and services embodied in these buildings would, of course, be different from the rate applied to materials and services used for maintaining, repairing, and renovating the existing housing stock. This would create distortions, raise administrative difficulties, and be a breeding ground for tax evasion and avoidance.

However, not all countries see it this way. Thus, the United Kingdom applies the standard rate to all construction other than the sale (or long-term lease) of new residential buildings, which is zero rated.[13] As a result, complications arise when "mixed work" is supplied, for example, the alteration and renovation of an existing house in combination with the construction of an adjoining new dwelling. Another baffling distinction is made regarding builders' hardware: fitted cupboards in kitchens are zero rated, but built-in units in bedrooms are taxed at the standard rate.[14]

Presumably, similar problems arise in Spain, which taxes new buildings at a lower-than-standard rate.[15] Spain attempts to limit the damage by stipulating that the standard rate continues to apply to construction work carried out by someone other than the building contractor,[16] but, in fact, the legal and practical mess may be largely the same as in the United Kingdom. Sweden used to tax new buildings by applying the standard rate to one-half of the taxable value, but since 1992 it has applied the standard rate on the full value.

Preferential treatment based on the end use of new buildings causes the same problems as it does for materials and services. Italy taxes the repair of historical buildings and the construction of low-cost housing at 4 percent. (In terms of VAT statistics, the country's housing stock probably consists largely of historical buildings and low-income housing.) Social housing programs are

[12]How complicated such exceptions to the rule may become is evident from the Irish VAT Act, which prescribes that the lower rate applies to, among others, "services consisting of the development of immovable goods, and the maintenance and repair of immovable goods including the installation of fixtures, where the value of movable goods (if any) provided in pursuance of an agreement in relation to such services does not exceed two-thirds of the total amount on which tax is chargeable in respect of the agreement. . . ." IRL VAT sixth sched. (iii).

[13]GBR VAT sched. 5, Group 8.

[14]*See* Tait *supra* note 10, at 83.

[15]*See* ESP IVA art. 91(3).

[16]The law states that the reduced rate applies to works resulting from contracts made directly between the developer and the contractor. ESP IVA art. 91(3).

Table 1. VAT Treatment of Immovable Property in Selected OECD Countries

	Construction			Lease		Sale		Alternative Tax	
Country	Building materials	Repair and maintenance	Newly constructed	Existing residential real estate	Other real estate[a]	Residential real estate	Other real estate[a]	Kind	Rate[b] (percent)
EU countries									
Austria	S	S	S	L	S	E	E	Property acquisition tax	3.5
Belgium	S[c]	S[c,d]	S[c]	E	E*[c]	E	E*[c]	Registration duty	12.5
Denmark	S	S	S	E	E*	E	E*	No, stamp duty	
Finland	S	E[f]	E	E	E	E	E	No, stamp duty	
France	S	S	S	E	E[c]	E	E[c,g]	Registration duty	6.9–18.6
Germany	S	S	E[h]	E	E*	E	E*	Property acquisition tax	2
Greece	S	S	S	E	E	E	E	Registration duty	9
Ireland	S[i]	L[j]	L	E	E*	E	E*	No, stamp duty	0–6
Italy	L	S[k]	S[k]	E	E[e]	E	E[c]	Registration duty	8
Luxembourg	S	S	S	E	E*	E	E*	Registration duty	10
Netherlands	S	S	S	E	E*	E	E*	Transfer tax	6
Portugal	S	S	E[h,l]	E	E*	E	E*	Registration duty[m]	8–10
Spain	S	S	L[n]	E	S	E	S	Registration duty	6
Sweden	S	S	S	E	E*	E	E*	No, stamp duty	
United Kingdom	S	S	Z[o]	E[n]	E*[p]	E	E*	No, stamp duty	

Selected other OECD countries									
Canada	S	S	L	E	L	E	L	None	
Iceland	S	S	S	E	S	E	S	None	
Japan	S	S	S	E	S	E	S	Transfer tax	4
New Zealand	S	S	S	E	S	E	S	No, stamp duty	
Norway	S	S	S	E	E	E	E	None	
Turkey	S	S	S	E	S	E	S	Transfer tax	4

Key: S = normally liable to the standard rate
L = normally liable to the lower rate
E = normally exempt from tax
Z = normally subject to the zero rate
* = optional registration and taxation are possible if the property is for use in a taxable activity.

Notes:
[a]In the member states of the EU and some other OECD countries, hotel accommodation, camping sites, and parking space are taxed.
[b]Special rates that may apply are not shown.
[c]Belgium applies an intermediate rate of 12 percent to public housing, such as dwellings supplied to regional housing corporations and apartment buildings for the elderly, the handicapped, the homeless, minors, and students. Work on such buildings is also taxed at 12 percent.
[d]In Belgium, renovation, repair, and maintenance services to dwellings that have been used as such for at least 20 years are taxed at the lower rate of 6 percent.
[e]Taxed if leased or sold by a commercial lessor.
[f]Finland taxes installation work relating to water pipes, sewers, heating, gas pipes, and electric wires.
[g]In France, the supply of building sites for social housing programs is taxed at the lower rate of 5.5 percent; other building sites are taxed at 13 percent. Traders in commercial property are subject to the VAT on gains; no credit is allowed for the tax on purchases, but the tax on repairs is creditable.
[h]In Germany and Portugal, newly constructed property is subject to the alternative tax.
[i]In Ireland, concrete is taxed at the lower rate of 12.5 percent.
[j]In Ireland, repair and maintenance services are taxed at the standard rate if their value is less than one-third of the work contract.
[k]In Italy, the lower-lower rate of 4 percent applies to work on specified (historical) buildings and the construction of low-cost housing.
[l]In Portugal, the lower rate of 5 percent applies to public work contracts and to construction work of housing development cooperatives.
[m]In addition, stamp duty at 0.75 percent is payable on property transfers, while construction work attracts a 0.6 percent stamp duty.
[n]In Spain, the standard rate applies to construction work carried out by someone other than the building contractor.
[o]In the United Kingdom, the standard rate applies to the supply of new commercial buildings.
[p]Leases in excess of 21 years granted by the original builder-developer are zero rated.

also favored in Belgium, Canada, France, and Portugal. Furthermore, Portugal levies the lower rate on public works contracts.[17] This is a needless complication, because raising the rate and increasing the subsidy would be a simple bookkeeping exercise that would deter evasion. Turkey exempts housing units of up to 150 square meters.[18] Presumably, some families are then tempted to buy two units and subsequently connect them.

Germany and Portugal exempt newly constructed buildings from the VAT, but apply instead the property transfer tax (registration duty).[19] The rate of the transfer tax is lower than the standard VAT rate; on the other hand, no credit is available for the tax on inputs. Except by coincidence, the sum of the transfer tax and the VAT on inputs will not be the same amount as the VAT that would have been levied on the total consideration for the new building. This could be a source of distortions and complications. Optional registration and payment of tax for business property, available in most EU countries, mitigate these effects.

B. Lease

No country in the OECD taxes or has ever contemplated taxing the imputed rental value of owner-occupied property under the VAT. Hence, information on this point is not shown in Table 1. If rental values of owner-occupied properties are not taxed, the equal treatment rule requires residential rents to be excluded from the VAT base. With the exception of Austria, all countries surveyed do indeed exempt the lease of residential real estate.[20] This does not necessarily mean that lessees pay less rent, because the VAT will have been paid at the time the dwelling was created. The exemption does, however, mean that lessors, like owner-occupiers, are stuck with an element of the VAT on repairs and alterations. This should not occur in Austria, which taxes residential rents at the lower rate of 10 percent.[21]

In all countries surveyed except Canada, Iceland, Japan, New Zealand, Spain, and Turkey, the lease of other real estate (commercial, agricultural, and government land and buildings) receives the same treatment as the lease of residential real estate. In principle, therefore, the leasing of real estate is exempt from the VAT. However, most countries mitigate or eliminate the potential cumulative effect of this approach by allowing lessors to opt for registration and payment of the VAT (treating them at par with other taxpayers: full credit for input tax and payment of tax on lease payments), provided

[17]PRT CIVA app. II, No. 3.7.

[18]Such residences were exempt from tax until December 31, 1995. Provisional arts. 8, 9, Law No. 3099, Official Gazette of Dec. 15, 1984, No. 18606.

[19]*See* DEU UStG § 4(9)(a); PRT CIVA art. 9(30), (31).

[20]*E.g.*, CAN GST fifth sched., pt. 1(6); IRL VAT first sched. (iv).

[21]AUT UStG § 10(2)(5). A tax on residential rents (not rental values) may be preferable if a country's real estate sector is dominated by large apartment complexes and hotels.

that lessees are also registered taxpayers (meaning that they can take credit for the tax on their lease payments) or agree to become registered taxpayers. This provision takes the "cascade sting" out of the exemption. In practice, the exemption-cum-optional-taxation approach may closely approximate the effect of the taxation approach in the six countries mentioned above. Given a choice, lessors will opt for the least-tax-expensive option, but they must take into account that the choice is irreversible. In Belgium, France, and Italy, lessors of furnished commercial real estate are always taxable with respect to the lease or sale of such real estate.

Countries that exempt leases of immovable property and hence housing services, however, do tax hotel accommodation and the rental of parking space and camping grounds.[22] An exemption applies if hotel and similar accommodations, such as boarding houses, are used for residential purposes. Usually, a simple period test, say, an uninterrupted stay of 30 days or more, is used to establish eligibility for the exemption. Under the Sixth Directive, permanently installed equipment and machinery are also taxed.[23] Without an explicit charging provision, such equipment and machinery would be exempt, because they are immovable by law. Finally, the directive also taxes the rental of safe-deposit boxes.[24]

C. Sale

As Table 1 indicates, all countries exempt the sale of previously occupied residential real estate, and most countries the sale of other real estate, too. Six countries (Canada, Iceland, Japan, New Zealand, Spain, and Turkey), however, tax the sale of other (nonresidential) real estate under their VATs. The same countries that allow lessors of real estate the choice of being taxed extend that right to sellers of real estate. Exemption means that increases in the value of the stock of housing services are not taxed (nor is a tax credit provided for decreases in the value). Interestingly, in France, the VAT is levied, albeit at the lower rate, on the realized capital gains of traders in real estate; a credit is allowed for the tax on repairs but not for the tax paid at the time of purchase. Not surprisingly, this approach resembles the treatment of secondhand goods bought and sold by registered businesses.

The VAT treatment of the sale or lease of immovable property, as described above, should cause little discrimination unless the purpose to which the building or the land is applied changes from exempt to business use or vice versa. In the event, the member countries of the EU provide for an adjustment period of up to ten years from the date of purchase.[25] If, say, after four years, a

[22]Sixth Council Directive 77/388 art. 13B(b)(1), (2), 1977 O.J. No. L 145/1.

[23]*Id.* art. 13B(b)(3).

[24]*Id.* art. 13B(b)(4).

[25]*Id.* art. 20(2).

building changes from exempt to taxable use, a tax credit is permitted of six-tenths of the tax originally denied. Conversely, if the building has been used for taxable purposes for, say, seven years, a change to exempt use implies that a VAT payment of three-tenths of the original tax must be paid. Annual apportionment of the tax, depending on the relationship between exempt and taxable use, is also possible. In Italy, the adjustment period is five years. In New Zealand, there is no time bar to the adjustment period.

V. Conclusion

This chapter has shown that there are two opposing points of view on the nature of the VAT. The economic point of view is that the VAT is a tax on current consumption activities, although feasibility considerations often dictate that the reach of the tax must be confined to market transactions and that stocks instead of flows must sometimes be taxed. The legal point of view, on the other hand, holds that what economists present as the exception to the rule actually is the rule. In other words, the VAT should be confined to transactions in the marketplace, and it is perfectly legitimate to tax stocks of consumption services as they leave the ring of registered businesses. The collection mechanism of the VAT is a quintessential feature of the tax rather than a means of reaching the consumption base.

The economic point of view holds considerable attraction for the theoretically inclined mind. However, no legislator has ever thought of, let alone proposed, taxing nonmarket consumption activities or durable consumption goods on the flow of services they provide. As the legislative history of every VAT indicates, the reach of the tax ends at the retail stage. Concessions to this view are not made on grounds of principle, but only as a means of blocking possible avoidance routes or to mitigate undue distortions. The *in rem* nature of the VAT considerably weakens the view that durable consumption goods should be taxed on the flow of services they generate to the owner.

The second-best solution, applied to housing services (exemptions of rents and rental values, taxation of newly created houses) by nearly all countries with a VAT, broadly satisfies generally accepted criteria of horizontal equity, neutrality, and feasibility. The tax method (tax all immovable property, unless exempted; exempt housing services and the sale of previously occupied dwellings) is, however, superior to the exemption method (exempt all immovable property, except new dwellings). Under the tax method, commercial exploitation of immovable property, other than houses, is fully taxed. Under the exemption method, increases in the value of commercial housing services are not taxed. Moreover, optional taxation causes differential effects. More generally, under the philosophy of the VAT, it is better and easier to define selective exemptions than to define selective charges to tax.

As the examples in this chapter show, the consistent and neutral application of the VAT to immovable property requires that all building activities, forms of leasing, and sales be taxed at the standard rate. Preferential rates cause distortions and raise administrative complications. Their effect may be undone if low-taxed activities, for example, repair and maintenance services, are supplied in combination with normally taxed goods, such as building materials or new buildings. Similarly, building materials, subject to the standard rate, may effectively attract a lower rate if supplied in combination with preferentially treated low-cost housing. Furthermore, it is essential that leases and sales be taxed at the same rate. In the immovable sector also, goods (buildings) and services (renting) have become nearly perfect substitutes. Equal treatment should be more fully achieved under the tax method.

In some countries, such as the Netherlands, the limited adjustment period[26] of ten years led to tax avoidance. Local governments, for instance, established legal entities from which they rented their buildings. The legal entity opted for registration; it charged VAT on the rent but was also entitled to a credit for the tax on the purchase of new buildings. After the expiration of the ten-year period, the buildings were sold tax free to the local governments. In the case of a building with a useful life of 40 years, this yields a VAT saving of three-fourths of the tax that should have been paid. To repair this loophole, the Dutch VAT law was changed. Currently, the option of registration and payment is available only if the immovable property is sold or leased to an entity 90 percent or more of the turnover of which consists of taxable transactions. Here, as in many other VAT matters, New Zealand has chosen the best approach: in addition to the tax method, it has an unlimited adjustment period. Moreover, New Zealand taxes local governments.

By any standard, transfer taxes (registration and stamp duties) are an anachronism. These taxes exhibit the same cumulative effects as a cascade turnover tax. In most countries, they yield little revenue. At best, they can be viewed as a proxy for the VAT that should have been levied on the increase in the value of immovable property realized at the time of sale. This increase represents the capitalized value of the increase in the value of the (housing) services of the immovable property that belongs in the VAT base. It would be better to abolish the transfer taxes and subject gains realized upon the sale of immovable property (including dwellings) to the VAT. This would justifiably resemble the treatment of other secondhand goods.

[26]*See supra* sec. IV(C).

8

Excises

Ben J.M. Terra

> Excise—A hateful tax levied upon commodities, and adjudged not by the common judges of property, but wretches hired by those to whom excise is paid.
>
> —*Samuel Johnson*

I. Introduction

A. Nature of Excise Taxes

According to the late H.C. Simons, an American professor of public finance, the only cogent defense of excises rests on Calvinist premises. Calvinism, according to Simons, divides mankind into the elect and those who are obviously damned for their next life. The elect noticed that the damned consumed large quantities of certain goods and liquors, providing an obvious reason for the elect to tax these goods and liquors. This taxation would properly prepare the damned for their fate while at the same time carrying what would otherwise be tax burdens for the elect. This explanation of excises, definitely not meant as a joke, can easily be refuted. The more southward one travels in Europe the less the Calvinist influence, but the larger the number of different specific taxes.[1]

[1]It is precisely this distinction among the member states of the European Union (EU) in relying on various excises that made a unanimous decision on harmonization so difficult. The instruction of art. 99 of the EEC Treaty to the Commission to examine, among other issues, how excise duties can be harmonized only resulted in a few directives on tobacco and many proposals for directives that have not been adopted. It took until the completion of the internal market (1992) to harmonize the excises within the EU, although it is admitted that it is based on a new concept of "general and flexible harmonization" or on the "least common denominator." *See* E. Stubbe, *Die Harmonisierung der besonderen Verbrauchssteuern in der Europäischen Gemeinschaft*, Zeitschrift für Zölle und Verbrauchssteuern 170 (1993).

The harmonization of the excises in the EU is based on three sets of rules: (1) one directive (92/12 of March 23, 1992, O.J. (L 76) 1, as amended) on the general arrangements for products subject to excise duty and the holding, movement, and monitoring of such products, known as the "horizontal directive," (2) three directives on the harmonization of the structures of the excises that are the subject of the general arrangements procedure, namely, mineral oils, alcohol and alcoholic beverages, and manufactured tobacco, and (3) four directives on the approximation of rates of duties applicable to the above-mentioned excises, referred to as the "Directives on rates." *See* Ben Terra & Peter Wattel, European Tax Law 145–46 (1993).

Value-added tax, as discussed in chapter 6, refers to a technique (the so-called credit of input tax based on the invoice method) of levying a turnover tax. The VAT is a general indirect tax on consumption. The general character of this tax requires that locally produced goods and imported goods be treated equally; thus, imports are equally subject to VAT.[2] The levy of VAT on importation of goods is not discriminatory (like import duties) but compensatory. VAT on importation is characterized by its *equivalent nature*. The indirect character of VAT is exemplified by the fact that VAT is remitted on exportation in accordance with the rules of the General Agreement on Tariffs and Trade (GATT). VAT is a general, as opposed to specific, tax on consumption. Excises are examples of specific taxes. The levy of excises on importation is equally characterized by its equivalent nature. Excises on importation are meant to compensate for the internal levy on identical or similar goods. The indirect character of excises is exemplified by the fact that excises are remitted on exportation in accordance with the GATT rules.[3]

Although sometimes applied to services, excise taxes are generally imposed on the sale of specifically listed goods. Import duties and VAT are based on the value of the goods concerned (ad valorem duties). Although a strong argument can be made in favor of charging excises on an ad valorem basis,[4] many excises are levied as specific duties; that is, they are imposed at a specific monetary charge per unit sold, for example, based on weight, quantity, or alcohol content, or in combination with ad valorem duties.

Because of their generally simple nature, excise tax statutes normally lack the technical complexity and need for great detail associated with, for example, income tax laws. Although excise taxes are administered by fiscal authorities, both their administration and their special problems are similar to those encountered in customs duties. The computation of the amount of tax owed is relatively simple. Typical problems involve classification and definition of goods subject to excise, questions about who is responsible for collecting the tax and when it is to be collected, how to treat leasing, and technical issues such as withdrawal from warehouse, how to deal with exempt purchasers or uses, how to handle returns, lost or damaged merchandise, exporter's refunds and issues related to effective dates, such as how to treat floor stocks at the time of the imposition, termination, or change in rate of a tax. An excise tax statute should provide as much guidance as possible with respect to these issues.

B. Terminology

The term "excise" has a historic connotation. As early as the Han dynasty (207 B.C.–A.D. 220) excises were levied on tea, liquor, fish, and reeds used for

[2]Since January 1, 1993, the taxable event of importation between member states of the EU no longer occurs.

[3]*See* discussion *infra* sec. I(C).

[4]*See infra* sec. I(D).

fuel and thatching.[5] Cnossen refers to a study according to which the word excise derives from the Middle Dutch *exijs*, which might be a modification of the old French *assise* meaning session, settlement, or assessment.[6] We submit that the word excise could also be derived from the Latin *excisere*: to carve, to cut out, referring to the carvings on a stick intended for measuring quantities of beer or liquor.

More important is the definition of excises. According to Cnossen, "broadly speaking, the distinguishing features of excise taxation are selectivity in coverage, discrimination in intent, and some form of quantitative measurement in determining the tax liability."[7] Cnossen's classification of excise systems is still useful:

> 1. *Limited excise systems* comprise at least the traditional excise goods: tobacco products, alcoholic beverages, and petroleum products as well as motor vehicles and various forms of entertainment. . . . However, all in all, the coverage of limited systems would not exceed 10–15 commodity groups, with closely related products (various petroleum products, or sugar and saccharine, for instance) being treated as one excisable item. 2. *Intermediate excise systems* consist of between 15 and 30 commodity groups. . . . 3. *Extended excise systems* comprise more than 30 commodity groups spanning almost the whole range of production activities in a particular country.[8]

This chapter is restricted to limited excise systems in the belief that it is preferable to limit excises to a few principal groups of products and to remove vexatious minor excises and regressive excises in favor of a general tax on consumption. A further restriction is that we will focus on the traditional excise goods, such as tobacco products, alcoholic beverages, and petroleum products. Under the subject "others," we discuss some design issues of other excises in general terms.

C. Territoriality

As with the VAT,[9] the two conflicting principles on which the territorial scope of excises can be based are the origin principle and the destination principle. Most countries have adopted the latter for both VAT and excises, resulting in so-called border tax adjustments. The issue of border tax adjustments reemerges with a certain regularity in discussions on world trade. Border tax adjustment refers to the treatment of taxes under the rules of the GATT, now

[5] *See* Sijbren Cnossen, Excise Systems 1 (1977).

[6] *See id.* at 160, ch. 1, n.1.

[7] *Id.* at 7. Certain narrowly based taxes are sometimes called excise taxes, even though they do not fall within traditional categories of excises. *See, e.g.*, USA IRC §§ 4940–48 (excise taxes imposed on tax-exempt organizations). These are beyond the scope of this chapter.

[8] Cnossen, *supra* note 5, at 13.

[9] *See supra* ch. 6.

embedded in the World Trade Organization (WTO). The provisions on the international treatment of internal taxes in the GATT are interpreted to mean that border tax adjustments are permitted for indirect taxes, but not for direct taxes.

Border tax adjustments are a surcharge on imports, which must not exceed the internal taxes or other internal charges levied on similar domestic products, and a refund of duties and taxes upon exportation in amounts not exceeding those that have accrued. Taxation on importation and remission of taxes or duties on exportation are also called "tax frontiers," "tax boundaries," or "tax barriers."

The application of border tax adjustments is voluntary, rather than mandatory. The Contracting Parties to the GATT may impose compensatory taxes on imports and may exempt, or remit, taxes on exports, but they are not required to do so.

In the 1960s, a proposal was made to modify the GATT rules by eliminating border tax adjustments altogether, under the assumption that adjustments result in unfavorable trade patterns. During the Tokyo Round (one of the major multilateral negotiations held under auspices of the GATT), the proposal to eliminate border tax adjustments was, however, rejected and the existing practices confirmed.

The concepts regarding subsidies and border tax adjustments are embodied in the GATT. However, there is no unified GATT provision dealing exclusively with border taxes. Besides article VI, dealing with antidumping and countervailing duties, the only GATT articles concerning border tax adjustments are article II on tariff concessions, article III on internal taxation on imports, and article XVI, adopted in 1955, on the border tax adjustments on exports.

Articles II and III govern border tax adjustments on imports. Article II prohibits import charges other than those provided in the GATT, but excludes from this prohibition the levy on imported products of "a charge equivalent to an internal tax imposed, consistently with Article III in respect of like domestic products." Article III provides that internal taxes shall not be applied to protect domestic production. Discrimination is also forbidden: imported products shall "not be subject, directly or indirectly, to internal taxes or internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products."[10]

D. Method of Charging

The two main methods of charging are specific rates, based on quantity, and ad valorem rates, based on value. Which is better is controversial, and may differ depending on the product and the details of implementation of the

[10]General Agreement on Tariffs and Trade, art. III(2).

charging method. Conventional policy generally advocates that all excises be levied on an ad valorem basis rather than on a specific basis, because this protects the base of the tax from inflation. This is particularly important in countries with high rates of inflation. "Nevertheless, the real value of revenues may be maintained under a specific-rate excise tax if there are regular adjustments of the rate to reflect inflation."[11] It may be argued that with periodic adjustments for inflation, revenues under a specific-rate system will still lag during the periods between adjustments[12] but that the lag can be mitigated by introducing "automatic" adjustments of the specific rates when inflation reaches a certain threshold. Without such automatic adjustment, there could be political pressures to cancel or postpone increases, based on the argument that the tax increases will just make inflation worse.[13]

"An additional reason for [advocating] ad valorem rates is that they are fairer for the less prosperous, whose economy brands under a specific rate would bear the same tax as the luxury brands of the affluent."[14] This argument is most relevant for excises that are imposed on luxury goods for the purpose of introducing progressivity to the system. For goods such as alcoholic beverages, specific rates, for example, based on the unit of alcoholic content (or a combination of specific and ad valorem rates) make more sense given the purpose of the tax.[15] The most compelling reason for recommending specific rates is based on the difficulties of determining the taxable value related to the stage of production or distribution where excise should be levied. The problem can be dealt with under a system of ad valorem rates by providing a presumptive minimum valuation for certain products.

There are two distinct types of excise taxes. Manufacturer's excise taxes are imposed on the producer or importer of a taxable good and included in the price paid for that good by the ultimate purchaser. Retail excise taxes, in contrast, are imposed at the point of sale to the ultimate purchaser. Although recent work in the applied theory of optimal taxation suggests that indirect taxes, including excises, should be imposed as close to the final sale as possible because of the potential for excises to have unexpected distributional and efficiency effects when imposed on intermediate goods,[16] the small number of

[11]William J. McCarten & Janet Stotsky, *Excise Taxes*, *in* Tax Policy Handbook 100, 102 (Parthasarathi Shome ed., 1995).

[12]*See* Ward M. Hussey & Donald C. Lubick, Basic World Tax Code and Commentary: 1996 Edition 306 (1995).

[13]*See id.*

[14]*Id.*

[15]*See* Leif Mutén, *Some Comments on the Basic World Tax Code*, 7 Tax Notes 179, 184 (1993). A study conducted for the European Commission, reported in the Commission Report on the rates of duty laid down in the various rates directives on the approximation of excises (July 1995), shows that "excise duty affects consumption of the different alcoholic beverages through their sensitivity of their specific price" and that "excise duty can also affect the market share of different categories of alcoholic beverage because of competition through prices."

[16]*See* McCarten & Stotsky, *supra* note 11.

taxpayers affected by a tax imposed at the manufacturer's level may involve an administrative advantage that outweighs the suggested advantages of levying as close to the final sale as possible. Because of problems of control, most excises in developing and transition countries take the form of manufacturer's taxes. However, under an ad valorem tax, the taxable value is presumably the price actually paid or payable. At the manufacturer's level, certain costs such as transportation, storage, or even part of the profit can be transferred to the next stage. This type of circumvention requires complex legislation dealing with such matters as what should be included in the value, and special rules for transactions with related parties. Thus, specific taxes may be better than ad valorem rates if tax administrative capacities are limited so that undervaluation of domestic goods or imports is a common problem. Under a specific-rate excise tax, disputes over valuation do not arise. The choice of manufacturer's taxes requires a more frequent use of specific taxes. Furthermore, ad valorem taxes at the manufacturer's level would be either excessive or related to a final consumption price that is not always known, unless it is fixed, as may be the case with tobacco.[17] This chapter will therefore assume the manufacturer's tax and a frequent use of specific taxes in the general discussion without, however, recommending what approach should be taken in specific cases.

E. Principle of Nondiscrimination

The GATT practices as discussed in section C are based on the principle of nondiscrimination between domestically produced and imported products. If an excise does not apply equally to both domestic production and imports, then, to maintain a given degree of protection, a given excise tax rate change will require a corresponding change in the tax rate on imports. In India, for example, changes are made simultaneously in excises and in levies on imports. In Latin America and the EU, excises typically apply to both imports and domestically produced commodities. Within the EU, the principle of nondiscrimination requires an identical excise on locally produced products and products produced in other member states. The identical treatment applies not only to identical goods but also to similar goods; as applied to the latter, this principle has resulted in an extensive body of case law of the European Court of Justice.

II. General Design Issues

It is advisable to limit excises to a few principal groups of products and to remove vexatious minor excises and regressive excises in favor of a general tax on consumption. In contrast to a general tax on consumption, for which a single set of rules suffices, each distinct principal group of excised products re-

[17] *See* discussion *infra* sec. III(C).

quires specific legislation with specific design issues.[18] It is nonetheless advisable to lay down in a single statute the arrangements common to all products subject to excise duties and to set out in specific subdivisions or separate laws the particular provisions relating to the structures and rates of duty on the distinguished products subject to excise duty. The statute should contain at least the following items: general provisions, taxable event, movement of goods, payment of the duty, reimbursement, and exemptions. The most important design issues are discussed below.

In this discussion, we draw heavily on the EU directive in this area, known as the horizontal directive.[19] This directive sets forth principles that member states must follow in drafting their excise tax laws. The discussion is not, however, a commentary on the horizontal directive, nor do we analyze the many provisions that relate to the treatment of transactions within the EU. Rather, we view the directive as setting forth useful guidelines and definitions that countries designing excise tax laws should take into account, even though not all the aspects of the directive will be relevant outside the EU.

A. General Provisions

A statute laying down provisions common to all products subject to excise duties usually starts with the *scope* of the statute itself. Particular provisions relating to the structures and rates of duty on the distinguished products can be set out separately.

The general provisions should define the *territorial application* of excises, in general, the territory of the country. For constitutional or other reasons (remoteness, autonomy, degree of development, etc.), certain parts of the territory may have to be excluded. It is highly recommended that the territorial scope of the tax be defined in the same manner as for VAT, so that there is a uniformity of application of the two taxes.

The *products subject to excise duties* should be mentioned. For example, "this statute applies to mineral oils, alcohol and alcoholic beverages, manufactured tobacco, and others as defined in articles [-], hereinafter referred to as excise products."[20] Here, or in the provisions containing rules for specific products, the items subject to tax will have to be defined.

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[18]*See infra* sec. III.

[19]*See supra* note 1. We also draw on Terra & Wattel, *supra* note 1, at ch. 7.

[20]Although it is advisable to limit excises to a few principal groups of products, the division of fiscal powers within a state, [con]federation, or economic union may allow for separate local excises. It is recommended that, in addition to VAT, the above-mentioned products be made subject to other (specific) indirect taxes only if determination of the tax base, the calculation, chargeability, and other aspects comply with the tax rules applicable to excise duties, based on the horizontal statute. If levels other than the central government retain the right to maintain or even introduce taxes on other products and services (provided that these taxes cannot be characterized as turnover taxes, i.e., a VAT), obviously it should be provided that these taxes may not give rise to border-crossing formalities in the trade within the state, [con]federation, or economic union.

It is recommended that the *definition* of the items subject to tax refer to the customs tariff, based on the harmonized system (HS),[21] a single harmonized method of classifying goods for customs, statistical, and trade purposes, that has been adopted by all the major trading nations, including the United States, the EU, and Japan. The advantage of using this approach is, in addition to the comparability of trade statistics, the use of a uniform "language" in international trade based on a systematic classification that avoids linguistic differences. In light of the destination principle,[22] the classification based on the HS may prevent disputes.

Finally, the general rules should provide which *definitions*, such as those for tax warehouse, suspension arrangement, and authorized warehousekeeper, apply for the purposes of the statute.[23] The definitions that may be required are discussed in the sections below, under the subject to which they pertain.

B. Taxable Event and Chargeability

The statute should provide for the taxable event, namely, that excise products are subject to excise duty at the time of their *production* within, or *importation* into, the territory of the country (as defined under the general provisions). A distinction should be made between the taxable event and the chargeability of the tax. "Taxable event" means the occurrence by virtue of which the legal conditions necessary for the tax to become chargeable are fulfilled, that is, production or importation. The tax becomes chargeable when the tax authority becomes entitled under the law at a given moment to claim the tax from a person liable to pay.[24]

Although production techniques may be different depending on the product subject to excise duty, the definition of the chargeability (see below) does not in principle require a definition of production. If for certain prod-

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[21] *See* Customs Cooperation Council, The Harmonized Commodity Description and Coding System (1984).

[22] *See supra* sec. I(C).

[23] The following definitions may apply:

> (a) authorized warehousekeeper: a natural or legal person authorized by the competent authorities . . . to produce, process, hold, receive, and dispatch products subject to excise duty in the course of his business, excise duty being suspended under tax-warehousing arrangement;
>
> (b) tax warehouse: a place where goods subject to excise duty are produced, processed, held, received, or dispatched under duty-suspension arrangements by an authorized warehousekeeper in the course of his business, subject to certain conditions laid down by the competent authorities . . . ; [and]
>
> (c) suspension arrangement: a tax arrangement applied to the production, processing, holding, and movement of products, excise duty being suspended.

Council Directive 92/12, *supra* note 1, art. 4.

[24] Notwithstanding that the time of payment may be deferred, for example, upon importation based on monthly payments.

ucts a definition is deemed to be necessary, it is better covered in the specific provisions dealing with the structure and rates of duty on the product in question.

Importation is to be defined as the entry of a product subject to excise duty into the territory of the country. The entry from territories excluded from the territory of the country for excise purposes under the general provisions also gives rise to the taxable event of importation.[25] This all-encompassing definition needs some refinement based on the customs legislation in force. Generally, customs legislation provides for a variety of approved treatments or uses of goods, such as placing goods in a free zone or free warehouse, re-exporting the goods from the territory to a third territory, or even the destruction of goods or their abandonment to the state. If the goods do not undergo such treatment or use, they must be declared to customs, in which declaration, depending on the national customs legislation, a variety of procedures are again possible, such as transit, customs warehousing, inward processing, processing under customs control, or release for free circulation.[26] The definition of the taxable event should make clear when the excise duty is deemed to be suspended and when the importation is deemed to take place.

Notwithstanding a clear-cut definition of the taxable event (i.e., production or importation), the occurrence of the event should not necessarily result in chargeability of the tax. The excise duty becomes chargeable at the time of *release for consumption* or when shortages are recorded (the meaning of these terms is discussed below).[27] The conditions of chargeability and the rate of excise duty to be adopted should be those in force on the date on which duty becomes chargeable at the place where release for consumption takes place or shortages are recorded. This requires some further explanation.

From both the state's and a producer's point of view, an immediate collection of duties in all circumstances would have a perverse effect. Produced goods may be exported, thus not requiring collection of tax or, if collected, resulting in refunds. For a product like wine, which may require time (to ripen) between production and consumption, taxation at the moment of production would result in an excessive burden. Therefore, produced or imported excise products may be held in a so-called tax warehouse without excise duty becoming chargeable (or may be placed under a customs-approved treatment or use).[28] This is called the

[25] *See supra* sec. II(A). An additional complication could be that the excluded territories form part of the customs territory of the country. Special mechanisms have to be created in order to monitor the entry from the excluded territory into the excise (and VAT) territory without interference by customs officials.

[26] *See* B.J.M. Terra, Community Customs Law (1995).

[27] *See* Council Directive 92/12, *supra* note 1, art. 6.

[28] *See supra* note 25. Therefore, the statute should stipulate that the production, processing, and holding of products subject to excise duty, where the duty has not been paid, are required to take place in a tax warehouse.

"suspension arrangement." Any departure from this arrangement, that is, a release for consumption, results in chargeability of the duty.[29]

Release for consumption may be defined as

- any departure, including irregular departure (i.e., without fulfilling the required formalities), from a suspension arrangement;
- any manufacture, including irregular manufacture,[30] of excise products outside a suspension arrangement; or
- any importation, including irregular importation, where excise products have not been placed under a suspension arrangement.[31]

It should be borne in mind that the taxation of excise products is based on the destination principle;[32] hence, the suspension arrangement makes it possible to postpone taxation until the products reach the country of destination.[33]

As mentioned above, the excise duty becomes chargeable at the time of release for consumption or when shortages are recorded. With regard to *shortages*, the statute should provide that authorized warehousekeepers shall be exempt from duty for losses occurring under suspension arrangements that are attributable to fortuitous events or force majeure (but not theft) and established by the competent authorities. They shall also be exempt, under suspension arrangements, from losses inherent to the nature of the products during

[29]Excise products coming from or going to third countries or territories where the excises are not levied can be placed under a customs procedure, for example, exportation. In these circumstances, with the exception of the procedure of release for free circulation or consumption, the excise duties on the goods are deemed to be suspended. When goods leave the customs procedure, they are deemed to have been released for consumption.

[30]As mentioned in note 28, it should be required that production, processing, and holding of products subject to excise duty, where the latter has not been paid, take place in a tax warehouse. The provision that manufacturing outside a suspension regime is treated as release for consumption triggers the taxable event and makes the tax become chargeable at the moment of manufacturing.

[31]Council Directive 92/12, *supra* note 1, art. 6.

[32]*See supra* sec. I(C).

[33]Only with regard to products acquired by private individuals for their own use and transported by them does the principle apply that excise duty is charged in the state in which the products are acquired. Sometimes, the acquisition is exempt and an exemption may be granted up to a threshold upon importation. Between the member states of the EU with regard to products acquired by private individuals for their own use and transported by them excise duty is charged in the state in which the products are acquired. Of course "own use" has its limitations. The horizontal directive specifies that excise duty becomes chargeable when products released for consumption in a member state are held for commercial purposes in another member state. Council Directive 92/12, *supra* note 1, art. 9(1). The directive provides for so-called minimum guide levels, below which quantities are not treated as held for commercial purposes, for example 800 cigarettes, 90 liters of wine, including 60 liters of sparkling wines. *Id.* art. 9(2). For mineral oil, the guide level is based on the form of transportation. Atypical transport, that is, other than in tanks of vehicles or in appropriate reserve fuel canisters, results in taxation in the member state of consumption. *Id.* art. 9(3).

production and processing, storage, and transport. The statute should lay down the conditions under which these exemptions are granted.

The statute should specify that the duty on shortages other than the losses referred to above must be levied on the basis of the rates applicable at the time the losses, duly established by the competent authorities, occurred or, if necessary, at the time the shortage was recorded. Furthermore, the statute should provide that the production, processing, and holding of products subject to excise duty must take place in a tax warehouse.

With regard to the *authorization* to operate a tax warehouse and the obligations of an authorized warehousekeeper, the statute should provide that the opening and operation of tax warehouses is subject to authorization from the competent authorities and that an authorized warehousekeeper shall be required to

- provide a guarantee to cover movement and, if necessary, to cover production, processing, and holding;
- keep, for each warehouse, accounts of stock and product movements;
- produce the products whenever so required; and
- consent to all monitoring and stock checks.[34]

C. Movement of Goods

Any departure (including irregular departure, i.e., without fulfilling the required formalities) from a suspension arrangement results in the chargeability of the excise duty. This is not always a desired result, because goods may have to move between places of production (or in general tax warehouses) or to a place or destination that will not result in the chargeability of the duty (e.g., exportation). The statute should prescribe that the movement of excise products under suspension arrangements must take place between tax warehouses or a tax warehouse and the customs office from where the products leave the territory. All such movements must be covered by the "accompanying document" (administrative or commercial). Under certain circumstances, even the movement of excise products already released for consumption (i.e., goods not, or no longer, covered by the suspension arrangements) may be covered by an accompanying document. The consignee of the movement of excise products under suspension arrangements may only be an authorized warehousekeeper. The authorized warehousekeeper[35] must return a copy of the accompanying administrative document, duly annotated, to the consignor of discharge, that is, to the authorized warehousekeeper who dispatched the goods. In this case, the authorized warehousekeeper is discharged from the duty-suspension arrangement.

[34]Council Directive 92/12, *supra* note 1, art. 13.

[35]Or the customs office where the products leave the territory.

The products are subject to excise duty upon arrival at the consignee unless they have been placed under a suspension arrangement or have been exported.

With regard to the provision *from whom the duty is due* when goods are moved between authorized warehousekeepers, a broad provision is suggested; for example, depending on all the circumstances, the duty shall be due from the person making the delivery or holding the products intended for delivery or from the person receiving the products for use.[36]

Notwithstanding the possible use of computerized procedures, all products subject to excise duty moving under duty-suspension arrangements must be accompanied by a document drawn up by the consignor. This document may be either an administrative document or a commercial document. To identify the goods and conduct checks, the packages should be numbered and the products described using the document referred to above. The consignor should seal each container when the authorities recognize the means of transport as suitable for sealing; otherwise, the consignor should seal the packages. Where an irregularity or offense has been committed in the course of a movement involving the chargeability of excise duty, the excise duty should be collected from the natural or legal person who guaranteed payment of the excise duties, without prejudice to the bringing of criminal proceedings.

D. Payment of the Duty

As mentioned above in cases of movement of goods, the duty is due from the person making the delivery, the person holding the products intended for delivery, or the person receiving the products. The law should also specify who must pay the excise duty when it becomes chargeable at the time of release for consumption or when shortages are recorded. However, authorized warehousekeepers are exempt from losses occurring under suspension arrangements that are attributable to fortuitous events, force majeure, and losses inherent to the nature of the products during production, processing, storage, and transport.[37]

As mentioned earlier, the movement of excise products under suspension arrangements must be covered by an accompanying document drawn up by the authorized warehousekeeper, who must provide a guarantee. A guarantee that is jointly and severally binding on the warehousekeeper and the transporter may also be required. If the copy of the accompanying document to be returned to the consignor does not reach him or her, the consignor is not dis-

[36]*See, e.g.*, Council Directive 92/12, *supra* note 1, art. 7(3). Or from a body governed by public law. *Id.*

[37]*Id.* art. 14.

charged from liability for the duty. The excise duty becomes due from the person(s) who guaranteed payment.[38]

E. Reimbursement

In appropriate cases, products subject to excise duty that have been released for consumption may, at the request of a trader in the course of his or her business, be eligible for reimbursement of excise duty by the tax authorities when the products are not intended for consumption in the state.[39]

In applying this provision, before the goods are dispatched, the consignor must request reimbursement from the competent authorities of the state and provide proof that the excise duty has been paid.

F. Exemptions

Products subject to excise duty should be exempted from payment of excise duty where they are intended

- for delivery in the context of diplomatic or consular relations;
- for international organizations recognized as such by the public authorities, . . . and by members of such organizations, within the limits and under the conditions laid down by the international conventions establishing such organizations or by headquarters agreements; . . .
- for consumption under an agreement concluded with other countries or international organizations provided that such an agreement is allowed or authorized with regard to exemption from VAT.[40]

"Eligibility for exemption may be granted in accordance with a procedure for reimbursing excise duties."[41]

States may exempt products supplied by tax-free shops that are carried away in the personal luggage of travelers leaving the country by air or by sea.[42]

Products supplied on board an aircraft or ship during the international passenger service are to be treated in the same way as products supplied by tax-free shops.

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[38]"States may require that products released for consumption in their territory carry tax markings or national identification marks used for fiscal purposes." *Id.* art. 21(1). Any state that requires the use of tax marking or national identification marks as set out above is required to make them available to authorized warehousekeepers of other states. *Id.* art. 21(2). However, each state may require that fiscal marks be made available to a tax representative authorized by the tax authority of that state. *Id.* Without prejudice to any provisions, they may, to ensure that this provision is implemented properly and to prevent fraud, evasion, or abuse, specify that states should ensure that these marks or markings do not hinder the movement of products subject to excise duty. *See id.*

[39]*See id.* art. 22(1).

[40]*Id.* art. 23(1). Presumably the reference to "members" of international organizations is to officials of such organizations, members usually being countries.

[41]*Id.*

[42]*See id.* art. 28(1).

III. Issues in Designing Specific Taxes

A. Mineral Oils

As mentioned in the introduction, one of the typical problems in drafting an excise statute is the classification and definition of goods subject to excise. In order to cover both national descriptions and the descriptions used internationally, the special provisions on the structure of excise duties on mineral oils should provide for a definition of (types of) mineral oil, referring to the codes of the customs tariff, based on the HS.[43] To avoid any form of substitution for those mineral oils for which no level of duty is specified, the statute should stipulate that mineral oil will be subject to excise duty if intended for use, offered for sale, or used as heating fuel or motor fuel. Also, any product not listed as a "mineral oil" must be taxed at the rate for the equivalent mineral oil when offered for sale or used as motor fuel or for heating purposes.

Notwithstanding the general preference for ad valorem duties, mineral oils are often subjected to specific duties. If consumer prices are not fixed, ad valorem prices at the production level could easily result in a shift of profit to later stages. Ad valorem duties levied at the retail level would result in too large a number of taxpayers. The special provisions could, therefore, provide that mineral oils be made subject to a specific duty calculated per 1,000 liters of product, for example, at a temperature of 15° Celsius; heavy fuels should be calculated per 1,000 kilograms.

In addition to the chargeable event, as defined in the horizontal statute, the specific provisions on mineral oils should specify that excise duty becomes due when (certain) products are used for such purposes as heating oil or motor fuel, which products are made subject to excise duty as mentioned above. Furthermore, it should be provided that excise duty becomes due when the conditions for exempt use or use at a reduced rate are no longer fulfilled. With regard to these exemptions or reduced rates, the law should provide for a list of activities, for example, mineral oils supplied for use as fuel for the purpose of air travel other than private pleasure flying, mineral oils used for the process of producing electricity, and so on. Care should be taken to minimize exemptions and to minimize the situations where an exempt product could be converted to a nonexempt use.

The statute must prescribe the rates that apply. As an example, Directive 92/82/EEC provides for the following rates[44] (calculated in European currency units (ECUs) per 1,000 liters of product at a temperature of 15° Celsius; heavy fuels are calculated per 1,000 kilograms): ECU 337 on leaded petrol, ECU 287

[43]*See supra* note 21.

[44]In contrast to the system as envisaged by the Commission with regard to the approximation of excise duties, the directive does not provide for a final rate that all member states must eventually reach. The directive merely prescribes minimum rates, which are applicable to only 7 of the 13 types of mineral oil mentioned in the structures directive.

on unleaded petrol, ECU 18 on heating gas oil, ECU 13 on heavy fuel, and ECU 100 on liquid petroleum gas and methane.[45]

B. Alcohol and Alcoholic Beverages

It seems self-evident that a modern excise on alcohol and alcoholic products should be based on the pure alcohol content of a product. History and tradition, however, make it virtually impossible to come to such a straightforward approach. Therefore, the special provisions on alcohol and alcoholic beverages may as well be built on the historic distinctions made between beer, wine, fermented beverages other than wine and beer, intermediate products, and ethyl alcohol. The special provisions on alcohol and alcoholic beverages are discussed below, based on this distinction.

To solve the problem of classification and definition, with regard to *beer*, the special provisions should provide that the object of taxation is beer covered by HS code 2203 or a mixture of beer with nonalcoholic drinks falling within HS code 2206, both with an alcohol strength more than 0.5 percent vol. The duty is based on the hectoliter/degrees Plato or hectoliter/degrees of actual alcoholic strength by volume. The rates should be fixed. As an example, Directive 92/84/EEC fixes the rate at ECU 0.748 per hectoliter/degree Plato or ECU 1.87 per hectoliter/degree alcohol of finished product.[46]

The statute may exempt from excise duty beer produced by a private individual, provided that the beer is consumed by the producer or by members of his or her family or guests and provided that no sale is involved. If sales are involved, consideration could be given to applying a threshold, set in the same manner as for the VAT, below which no excise duty is due.

With regard to *wine*,[47] a distinction could be made between "still wine" and "sparkling wine."[48] Still wine (falling within HS codes 2204 and 2205) has an alcoholic strength of between 1.2 and 15 percent vol or between 15 and 18 percent vol. In both cases, the alcohol must be entirely of fermented origin.[49] This distinction could be made to allow for a higher duty on wine that has a strength of between 15 percent and 18 percent vol. Sparkling wine has an al-

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[45]Council Directive 92/82, arts. 3–7, O.J. (L 316) 19, 19–20.

[46]Council Directive 92/84 art. 6, 1992 O.J. (L 316) 29, 30.

[47]It may be considered to exempt small wine producers from the requirements of operating a tax warehouse and from the other requirements relating to movement and monitoring. *See supra* secs. II(B), (C). Where these small producers themselves move their products within the territory, they should be required to inform the relevant authorities and comply with the requirements for an accompanying document. "Small wine producers" could be understood to mean persons producing on average less than 1,000 hectoliters of wine a year. If such an exemption is introduced, the tax authorities should be informed by the consignee of wine deliveries received by means of the accompanying document referred to above.

[48]Council Directive 92/83 art. 8, 1992 O.J. (L 316) 21, 23.

[49]*Id.* art. 8(1).

coholic strength of between 1.2 percent and 15 percent vol and is mainly distinguished by the use of "mushroom stoppers."[50]

The excise duty should be fixed by reference to the number of hectoliters of finished product; in principle, the same duty should be applied to all still and sparkling wines, although it is not necessary that the duty on still and sparkling wines be the same.

An exemption for private production may be granted under the same conditions as for the production of beer.

Furthermore, the specific statute could make a distinction between "other still fermented beverages" and "other sparkling fermented beverages," referring to the relevant HS codes and actual alcohol strengths, the details of which are not discussed here.[51] The provisions for the establishment of the duty on these fermented beverages other than wine and beer are identical to those on wine. If this choice is made, the statute should provide that, for the application of the horizontal statute, references to wine are deemed to apply to the products referred to above.

Intermediate products are to be defined on a residual basis, that is, falling within HS codes 2204, 2205, and 2206 and having an actual alcoholic strength of between 1.2 percent and 22 percent vol, but not covered by the definition of beer, wine, or other fermented beverages.[52] The duty on intermediate products is also to be based on the number of hectoliters of finished products. Consideration could be given to applying a single reduced rate to intermediate products with a strength not exceeding 15 percent vol under certain conditions.[53]

Ethyl alcohol covers all products of HS codes 2204, 2205, and 2206 (see the products mentioned directly above) whose alcohol strength exceeds 22 percent vol, products whose alcohol strength exceeds 1.2 percent vol that fall within HS codes 2207 and 2208 (even when they form part of a product mentioned in other chapters of the HS), and potable spirits containing the above-mentioned products, whether in solution or not.[54] The excise duty may be fixed per hectoliter of pure alcohol at 20° Celsius.[55]

C. Tobacco

It is sufficient to provide an all-embracing definition of tobacco products, (as distinct from the other products, no reference need be made to the HS code), namely, cigarettes, cigars, cigarillos, smoking tobacco, snuff, and chew-

[50] *Id.* art. 8(2).
[51] *See id.* art. 12.
[52] *Id.* art. 17(1).
[53] *See id.* art. 18(3).
[54] *Id.* art. 20.
[55] *Id.* art. 21.

ing tobacco. Because rolls of tobacco for making one's own cigarettes must be taxed as cigarettes, smoking tobacco may be distinguished between "fine-cut tobacco for the rolling of cigarettes" and "other smoking tobacco." Cigarettes are defined as "(a) rolls of tobacco capable of being smoked as they are and which are not cigars or cigarillos . . . ; (b) rolls of tobacco which by simple non-industrial handling are inserted in cigarette-paper tubes; or (c) rolls of tobacco which by simple non-industrial handling are wrapped in cigarette paper."[56]

Furthermore, the statute should provide for exemptions or refunds, for example, for manufactured tobacco that is destroyed or reworked by the producer.[57] The following definition of a manufacturer could be given: a natural or legal person who converts tobacco into manufactured products prepared for retail sale. With regard to the rates, we present the EU example. A manufacturer is free to determine the maximum retail selling price for each of the products for each of the member states in which the products in question are to be released for consumption. Consumption taxes on cigarettes comprise

- a specific excise duty per unit of the product,
- a proportional excise duty calculated on the basis of the maximum retail selling price, and
- a VAT proportional to the selling price.[58]

The member states must apply an overall minimum excise duty (specific duty plus ad valorem duty excluding VAT) the incidence of which must be 57 percent of the retail selling price (inclusive of all taxes) for cigarettes of the price category most in demand.[59] With regard to the taxes on manufactured tobacco other than cigarettes, the member states are free to apply either an ad valorem duty calculated on the basis of the maximum retail selling price, or a specific duty by quantity, or a combination of both provided that the overall excise duty is at least equivalent to

- 5 percent of the retail selling price inclusive of all taxes, or ECU 7 per 1,000 items or per kilogram for cigars or cigarillos;
- 30 percent of the retail selling price inclusive of all taxes, or ECU 20 per kilogram for fine-cut smoking tobacco; or
- 20 percent of the retail selling price inclusive of all taxes, or ECU 15 per kilogram for other smoking tobaccos.[60]

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[56]Council Directive 79/32, art. 3(1), 1979 O.J. (L 10) 8, 9 as amended by Council Directive 92/78, art. 2, 1992 O.J. (L 316) 5, 6.

[57]Council Directive 72/464, art. 6a, 1972 O.J. (L 301) 1 as amended by Council Directive 92/78, art. 1, 1992 O.J. (L 316) 5, 6.

[58]Council Directive 92/79 art. 1(2), 1992 O.J. (L 316) 8, 8.

[59]*Id.* art. 2.

[60]Council Directive 92/80 art. 3(1), 1992 O.J. (L 316) 10, 10.

D. Others

As discussed earlier, it is advisable to limit excises to a few principal groups of products and to refrain from minor excises in favor of a general tax on consumption. Specific taxes, for example, on matches, lighters, playing cards, sugar, chocolate, nonalcoholic drinks, and carbonated drinks, should be relegated to the realm of curiosities. If any consideration is given to taxing other products, as mentioned in the sections above, or services, it is recommended that the advantages (revenue) be weighed against the disadvantages, such as discrimination, substitution, and administrative costs.

In various countries a tax on motor vehicles is applied, which for revenue and arguably[61] environmental purposes is treated differently from VAT, although legislation for the two is similar. Some specific design issues of a motor vehicle tax are the definition, for example, motorcars and other vehicles (HS code 8703), buses (code 8702), and trucks (code 8704); the taxable event, meaning the importation or, for domestically produced items, the sale by the producer (i.e., the person who manufactures, produces, assembles, or rebuilds a motor vehicle) or use of the vehicle by the producer before any sale, which is treated as a sale.

No excise is to be imposed on the transfer between authorized warehousekeepers and upon exportation.

Special attention should be given to exemptions that are advocated for social reasons or to avoid intermediate costs on export goods. (For this reason, HS code 8701—applying to tractors—is not included in the definition, nor is code 8705, which covers vehicles, such as mobile cranes, road sweepers, etc.) It is worth considering granting an exemption (based on a refund, or a deduction in the framework of the VAT legislation) for commercial and public vehicles (such as cabs, police cars, buses, and trucks). The fact that these motor vehicles are subject to the motor vehicle excise prevents purchases of such vehicles to be used, without or after adjustments, as passenger cars; the latter results under the definition of production in a taxable event.

Considering the extensive range of prices—not necessarily related to specific aspects, such as weight or engine capacity of the vehicles—and the resulting regressivity of specific taxes, an ad valorem tax is preferred. The tax for imported and locally produced vehicles should be based on the current average retail price in the principal markets of the country.[62] Special attention should be paid to the exemptions on importation, for example, for used household effects. Exempt importation of used motor vehicles, for both VAT and excise purposes, should be allowed only under restricted conditions.

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[61] The Danish example shows that too high a tax on motor vehicles results in a polluting old national fleet of cars, requiring tax facilities to replace old cars for less-polluting new vehicles.

[62] The so-called accessories create a problem; if imported separately or sold separately, they escape taxation. HS code 8708 provides a good starting point for the articles to be subjected to the excise on motor vehicles.

9

Tax on Land and Buildings

Joan M. Youngman

The thing generally raised on city land is taxes.

—*Charles Dudley Warner*

I. Introduction

Taxes on immovable property, or land and buildings, as considered in this chapter generally take the form of an annual percentage of asset value. The simplicity of this concept can conceal a number of important drafting issues, some of which require a prior clarification as to the goals of the tax.[1] The primary reasons for imposing a property tax include incentives for efficient land use, a tax base that cannot be withdrawn from production, and establishment of an autonomous revenue source for local government.

Drafting a tax on land and buildings poses a number of challenges that may be surprising and frustrating in light of the simplicity of a typical property tax statute. These arise in part because many crucial issues regarding the tax resist uniform solutions. Instead, appropriate choices rely upon political, social, and economic judgments that must precede drafting but that are often not addressed until the drafting process brings them to policymakers' attention. Examples include whether to tax land and buildings together, to tax them separately at different rates, or to exempt structures; and whether the measure of the resulting tax base is to be market value, value in current use, acquisition cost, area, or some other quantity. A second set of critical issues concerning the operation of the tax may be too detailed to be addressed in the law itself, although it should be drafted with an understanding of, and an attempt to minimize, their potential difficulties. Numerous cases have addressed the meaning of "market value" when applied to property that has not been the subject of a recent sale; similar complexities arise with the definition of ownership and of

[1]*See* Janet Stotsky & Zühtü Yücelik, *Taxation of Land and Property*, *in* Tax Policy Handbook 185 (Parthasarathi Shome ed., 1995).

property itself. In the case of a tax on land and buildings, the somewhat deceptive simplicity of the legislative language requires greater stress upon consideration of underlying policy issues. This chapter reflects that balance.

A. Why a Property Tax?

A tax on ownership and other legal interests in land and buildings can serve important fiscal, political, and legal objectives. It is critical to identify these functions, for modest initial collections may not appear to justify the administrative costs of the tax on revenue grounds alone.

1. *Local Government Finance*

A property tax is often designed to provide an independent source of local government finance, whether or not collected and administered locally. A tax on land and buildings offers a revenue base that, unlike sales, payroll, or income, cannot readily shift to a neighboring jurisdiction. This is one reason that immovable property[2] is appropriate for a special form of taxation that does not extend to movable property, such as inventory, equipment, and household goods.

Land and building values are also frequently associated with services provided by local governments, such as fire and police protection and road maintenance. However, this benefit justification has important limitations. Often, the properties that place the highest burdens on local services and pose the greatest fire and safety risks are poorly maintained structures of low value. More expensive buildings may be better maintained, built more recently and to more exacting safety standards, and even protected by private security arrangements.

An equally limited but politically significant justification rests on ability to pay, demonstrated in part by ownership of valuable property. The weaknesses of this rationale are readily apparent, because the tax reaches only one form of property and even that generally in a gross rather than in a net form, with no offset for mortgage indebtedness. These objections argue against excessive reliance on a property tax but not against the tax itself. Particularly in light of the ascendancy of consumption-based taxes, there is an important place for a tax upon a significant segment of wealth, especially when that segment is often subject to favorable income and inheritance tax treatment.

2. *Defining the Public Claim on Property Value*

The role of a property tax in defining property rights may be among its most significant contributions to economies in transition, one often overlooked when the levy is considered solely as a fiscal instrument. A period of

[2]*See infra* sec. II(A); *supra* ch. 3, sec. V(D)(3).

privatization and restitution presents critical choices as to the division of public and private rights in property. The economic advantages of a system of private ownership, together with intense political reaction against the abuses of state control, frequently conflict with deeply held beliefs in the need for a continuing public interest in the permanent and irreplaceable heritage of immovable property. This conflict can arise most strongly in the case of land, whose supply cannot be expanded and whose existence is not the result of individual effort, but similar issues arise with regard to the privatization of buildings. Clarification of a continuing public claim upon a portion of land value in the form of an annual tax can help reconcile these competing positions.

3. *Inelastic Tax Base*

The inelasticity of a land tax base offers a means of raising revenue without distorting the economic signals that guide the production process. The tax will not affect the supply of land (leaving aside for the moment specialized cases such as land reclamation) and thereby imposes a lower total economic burden than would an alternate means of raising the same amount that did affect the supply of the taxed good.

4. *Equity Arguments*

An important political debate sometimes centers on the nature of land value as an "unearned increment," an asset attributable to social growth and public investment rather than to individual effort, and therefore appropriate for special forms of taxation. This view of land value does not properly apply to value attributable to trade and investment that have relied upon long-established systems of property rights. In that case, land wealth can represent a purchase made possible by other forms of productive effort. Of course, any tax can upset settled expectations and investor reliance, and, with sufficient notice and a gradual introduction, these detrimental effects may be greatly diminished. But the difficulty presented by this particular rationale for land-value taxation extends beyond issues of transition and implementation. The justification for a tax on "unearned" wealth is undermined when that wealth represents an investment of accumulated earnings. The alternative of a split tax base that falls more heavily on post-acquisition gains than on initial investment presents a complex administrative challenge. Individual value increments are more easily captured by a tax on realized gains than by an annual tax on property value.

Conversely, the argument for land-value taxation can be most powerful when a system of property rights is in the process of development. At this point, establishment of a continuing public claim to some portion of that value can be taken into consideration by investors formulating their bids for the property. Problems of notice and reliance arise only when a new tax is introduced after these purchases are completed. They grow more acute if the tax is

capitalized into property value and so falls entirely on the owner at the time of its introduction.

Equity considerations also arise with regard to the effect of a property tax on the distribution of ownership rights. As Bahl and Linn have written,

> [a]n equity argument may be at the heart of the matter: urban land prices are frequently so high that low-income groups cannot afford to purchase land, given their disposable incomes and the prevailing capital market conditions, which prevent access to mortgage credits at affordable interest rates. To the extent that the revenue from property taxes is capitalized into lower current land values (since the tax reduces the expected future private yield on the land), it partially expropriates landownership rights from the present owner and constitutes a loan to future owners, who can now acquire the land at the lower price but will have to pay property taxes in the future. If low-income groups cannot buy land because they lack liquidity and access to capital markets, property taxation may be one of the policy instruments to improve their access to landownership.[3]

Each of these rationales for property taxation applies equally to all types of land—agricultural, commercial, industrial, residential, and open space—as well as to land held by all types of private owners, whether individuals or enterprises. Similarly, the justification for a tax on buildings does not distinguish among them on the basis of type, use, or ownership. The multitude of special provisions that in fact differentiate among classes of land and buildings in nearly all systems of property taxation generally respond to political conditions and historical developments rather than to economic or legal considerations. For example, preferential taxation of owner-occupied housing reduces the tax burden on an important and affluent political constituency. Provisions of this type may be unavoidable to some degree, but simplicity and neutrality are best served when such preferences are minimized.

B. Drafting Issues

The elements to be specified in drafting a property tax are similar to those required for other levies: (1) definition of the tax base, (2) identification of the parties responsible for payment, (3) determination of the tax rate, and (4) assignment of administrative functions and tax revenues among levels of government. None of these has a single optimal resolution. The preferred method for addressing each issue will depend upon prior political and economic judgments, particularly with regard to the feasibility and desirability of autonomous local government. A practical evaluation of any proposed legislation must examine such questions as these:

[3]Roy W. Bahl & Johannes Linn, Urban Public Finance in Developing Countries 168 (1992).

- How is the system of identifying properties and taxpayers coordinated with current land and property records? What agencies will be responsible for maintaining this information?
- Will the proposed division of revenue between local and central governments serve the goals set for the tax? For example, will it permit local governments to undertake new responsibilities, and will it offer the government agency responsible for administration of the tax an incentive for efficient collection?
- Will the interest and penalty provisions encourage a reasonable level of compliance, particularly if this is a new tax?
- Are land-policy goals for the tax, such as control of price inflation and discouragement of speculation, realistic?

This chapter will examine alternative approaches to these issues, and examine their benefits, drawbacks, and consequences.

C. Terminology

References to taxes on immovable property as "property taxes" require some clarification. In a technical sense, "property" consists of a set of legal rights pertaining to a specific object;[4] a property tax is not imposed on the physical land and buildings, but rather on intangible rights to them. Although differentiating between a tax on a building and a tax on the rights of ownership of a building may seem a semantic exercise, this distinction takes on practical importance when partial interests that do not rise to the level of ownership are subject to tax. For example, countries that do not recognize private ownership of land but recognize private rights of use of land still have a system of private property appropriate for taxation.[5]

With these caveats, this chapter will use the terms "property taxation," "taxation of immovable property," and "taxation of land and buildings" interchangeably to mean the taxation of legal interests in land and improvements to land, including buildings, with appropriate distinctions when a choice among technical terms would affect the substance of the legislation.

The term "assessment" often gives rise to confusion, because in the property tax context it is commonly used to mean "valuation." This chapter will refer to valuation as a part of the assessment function, which includes the entire process of establishing tax liability.

A "cadastre," or official property register, can take a number of forms. A legal cadastre lists title or ownership to land and buildings; a fiscal cadastre[6]

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[4]Restatement of Property §§ 8, 14–18 (1936)("real property" defined as a set of estates).

[5]*See* CHN LT.

[6]"The basis of a good property tax practice is a full fiscal cadastre. This would involve describing and defining boundaries for every property (cadastral maps), establishing ownership or taxpayer liability, valuing the land, and if necessary describing and valuing all improvements on the land." Bahl & Linn, *supra* note 3, at 109 (footnotes omitted).

contains tax information, such as valuations and assessments; and a physical cadastre deals with parcel boundaries and building information. Because these functions are closely related, cadastre is often used to refer generally to the combined set of records, an integrated or master cadastre.

II. Legal Issues in Defining the Tax Base

A. Types of Property Subject to Tax

A wide variety of definitions of property have been used in determining the base of a property tax. Where this levy was expected to function as a wealth tax, as in the United States during colonial times, an expansive definition encompassed all types of property, whether movable, immovable, tangible, or intangible. Often termed a general property tax (as opposed to an immovable property tax), this type of gross wealth tax became untenable as financial assets and other intangibles that are inherently difficult to identify and assess grew in importance. Replacement of the general property tax with a tax on immovable property, complemented by an income tax, was an important goal of nineteenth-century tax reform. The Russian model of a balance sheet tax on enterprise assets is a specialized example of a general property tax, limited to one particular sector of the economy. It functions more as a specific business tax than as a property tax.[7]

A property tax limited to tangible assets may still reach movable property, such as inventory, machinery, and household goods. Their inclusion in modern property tax systems is generally justified only on grounds of revenue. Like financial assets, they are difficult to identify and assess and are readily concealed and easily removed from the taxing jurisdiction. Particularly when such property is held by individuals rather than by businesses, attempts to tax it can result in an administrative burden out of proportion to revenue yield. One exception is the taxes sometimes imposed on registered assets, such as automobiles, whose ownership and approximate value are a matter of record. Again, these function more as specialized fees than as property taxes. They are not a natural component of a tax system intended to reach land and buildings. A number of countries impose a broad tax on net wealth; this is discussed in chapter 10.

Within the category of immovable property itself, an important choice exists between a tax on land and a tax on land and buildings alike. Buildings do not share many of the unique characteristics that recommend land as the base of a special tax—its true immovability, its inelastic supply, and its value drawn from nature and social development rather than from individual effort. However, unless a tax on land is to function as a "single tax" and the sole

[7]*See* RUS TAE.

source of government revenue, it will operate in conjunction with other levies of a different nature. A tax on buildings, considered on its own merits as a component of a mixed revenue system, may logically be enacted together with a tax on land. In this case, however, specifying distinct rates for land and for buildings permits the option of taxing land more heavily, as may be appropriate for a commodity in inelastic supply.

The definitions of immovable property or of land for purposes of the property tax may differ from the definitions of those concepts that are given in the civil code or in other legislation. The definition of buildings or of immovable property is the subject of many disputes in marginal cases, such as those dealing with otherwise movable property incorporated into immovable structures ("fixtures," such as elevators and heavy machinery) or small buildings such as kiosks, or large equipment such as transmission towers and pipelines that may or may not be considered movable. The definition of land can give rise to similar complexities when land and improvements are distinguished for tax purposes. Improvements other than buildings, such as grading, irrigation, and paving, could properly be considered outside the base of a land tax designed to encourage investment by reaching only site value.

A typical definition of "land" that does not try to address these issues states " '[l]and' means the solid material of the earth whatever may be the ingredients of which it is composed. . . ."[8] *Black's Law Dictionary* includes such definitions as "any ground, soil or earth whatsoever; including fields, meadows, pastures, woods, moors, waters, marshes, and rock," and "the material of the earth, whatever may be the ingredients of which it is composed, whether soil, rock or other substance, and includes free or occupied space for an indefinite distance upwards as well as downwards, subject to limitations upon the use of airspace. . . ."[9] This last reference makes the important point that not only surface rights but also air rights and mineral rights must be considered in defining the property subject to tax and determining how it is to be assessed when these rights are held by different taxpayers.

B. Measure of the Tax Base

Definition of the tax base requires a number of crucial choices with regard to determination of the property attributes that will be valued for taxation and the form that valuation will take.

1. *Market Value as a Tax Base*

Legislation implementing a value-based system, the most prevalent in international practice, must take into account the measure of that value and the

[8]Cal. Water Code § 34014 (West 1984).
[9]Black's Law Dictionary 789 (5th ed. 1979).

degree of precision with which it is to be estimated. Statutory definitions of market value vary from the terse to the expansive, from the standard of a willing buyer and willing seller to the following suggested language from the 1976 Layfield Commission report in Great Britain:

> The value of the hereditament shall be the amount which the hereditament might reasonably have been expected to realize if sold by a willing vendor in the open market freehold with vacant possession at the relevant date with the benefit of any easement or other right inuring for the benefit of the hereditament and subject to any easement or other right subsisting for the benefit of other land and to any other restriction statutorily imposed upon the hereditament and on the assumptions that the use of the hereditament would be permanently restricted to that existing at the time of the valuation, including any change of use for which no planning permission would be required, that no alteration to the hereditament would be made other than any alteration for which no application for planning permission would be required, and that the hereditament was in the state of repair at the time of valuation which might reasonably be expected by an occupier of the particular property having regard to its character, its environment, and to the neighborhood in which the hereditament is situated.[10]

This extremely unwieldy formulation was offered by the Department of the Environment as "A Possible Definition of Capital Value for Rating Purposes," and its intent may have been to make the change to a capital value base appear as awkward as possible. In fact, most states in the United States implement a capital value base with no more than the willing buyer-willing seller statutory language.[11]

This lengthy definition is useful, however, in attempting to respond to numerous potential questions as to the interpretation of "market value." It points to issues that will need to be addressed, whether by legislation, regulation, litigation, or custom. For example, legal interests in property are frequently divided among multiple parties, whether through public regulation such as zoning, rent control, and environmental restrictions or through private arrangements such as leases or trusts.

The need to recognize a diminished market value by reason of such restrictions in some but not all such cases produces the most complex legal challenges to property assessment. It may seem unfair to ignore an involuntary, government-imposed restriction such as zoning, but zoning restrictions may be changed and market prices may reflect that expectation. Most private, voluntary, profit-motivated restrictions may be considered similar to joint ownership arrangements,[12] which need not affect property assessment. Just as the

[10]Layfield Commission, Local Government Finance Report, 1976 Cmnd 6453, at 441.

[11]*See, e.g.*, Cal. Rev. & Tax. Code § 110 (West Supp. 1995); 98 NY Jur. 2d, Taxation & Assessment § 303 (Law. Co-op. 1992).

[12]*Cf.* vol. 2, ch. 19 (discussion of ownership interests in legal persons).

assessor is not required to examine all legal agreements in order to attribute the appropriate amount to each partner in a shared tenancy, so can the effect of leases and other divisions of rights in property be subsumed under a unitary valuation of the undivided estate. While this approach is logically impeccable, it encounters severe resistance when it produces a high assessment upon property whose owner is laboring under the burden of an unfavorable lease or other legal arrangement.

A similar definitional problem arises when the value of property to its owner diverges drastically from its sale value. Specialized manufacturing and assembly plants may constitute a major portion of a jurisdiction's property value on the basis of their depreciated cost but command a market price that reflects only salvage value. Problems such as these have led to criticism that the willing buyer-willing seller standard identifies "not what a real buyer and a real seller, under the conditions actually surrounding them, do, but what a purely imaginary buyer will pay a make-believe seller, under conditions which do not exist."[13] The imaginary nature of the buyer and seller is not necessarily objectionable if the computation leads to an otherwise acceptable tax base. The greater problem is the lack of certainty introduced by speculation upon the bargain that would be reached by imaginary parties.

Complex valuation issues of this type arise under any nonformulary approach to measuring the tax base, but this does not establish the superiority of a formula in any specific situation. Formulary elements are also subject to dispute and necessarily provide less information on the wealth or ability to pay represented by the asset being taxed. In a functioning market system, property owners are often extremely well informed as to the value of their holdings and are thus able to supply an immediate check on the accuracy of their assessments.

2. *Capital Value and Annual Value*

Property taxation in the United Kingdom was traditionally based on the annual rent a parcel would command if vacant and available for let, while in the United States the tax was based on sale price or capital value. Where the current use of property is also the most economically profitable one, these two measures will stand in a predictable relationship to one another. A tax on annual value can be expressed as a tax on capital value, and vice versa, by reference to the rate of return expected from income-producing property.

The two standards diverge when a prospective purchaser would bid an amount unrelated to current yield in the expectation of a different and more profitable use in the future. The capital-value base has the advantage of more closely approximating a tax on immovable property wealth and more effectively discouraging speculative withholding of land ready for development.

[13]McGill v. Commercial Credit Co., 243 F. 637, 647 (D. Md. 1917).

These economic advantages are political drawbacks, however. The annual-value base follows more closely the realized cash income with which owners may expect to pay the tax and exerts less development pressure on open space and agricultural land bordering urban regions. There is no need to elaborate the political reaction to taxation at levels requiring sale or mortgage of family farms, open space, and elderly taxpayers' residences.

The problems of "cash-poor" taxpayers deserve special attention because they illustrate the potential conflicts between economic and political considerations with respect to tax structure. One economist has commented that "welfare cases should be treated by the welfare system on an impartial basis, without special favor to property owners. To use property tax relief as a substitute for welfare is to distribute welfare in proportion to wealth, surely an odd notion."[14] From an economic perspective, this problem might be resolved by the availability of financial intermediaries willing to extend loans secured by the property subject to tax. However, few taxpayers have participated in programs in the United States and Canada in which taxing jurisdictions offer extremely low-interest tax deferral to senior citizens willing to accept this debt as a lien upon their property. Intense concern for preserving family property as an unencumbered asset rendered these programs unacceptable to most of their intended beneficiaries.

Similar issues of highest and best use arise in the valuation of structures. If a building no longer represents the most profitable use of its site, may the land value assume that a purchaser would plan to replace it? In the United Kingdom, the answer is generally negative, under the principle of *rebus sic stantibus*, which requires that property be valued in its present condition. In the United States, considerations of highest and best use would permit this approach—valuing the property not as if the replacement had already been built, but in light of alternate potential uses. These divergent approaches to valuation may reflect the United Kingdom's more restrictive interpretation of private development rights, illustrating the close relationship between property law and the structure of an appropriate property tax system.

3. *Income-Based Valuation*

The problem of cash-poor property owners has sometimes given rise to another form of preferential assessment, one based upon an estimate of the income earned from the current use of the parcel. This "current use" taxation is designed to reduce development pressure on farmers and owners of open space ready for development in the urban fringe. When drafted simply as a tax reduction, this provides no guarantee that the land will not be developed in the future, and so perversely subsidizes speculation by reducing the cost of with-

[14] Mason Gaffney, *quoted in* Henry J. Aaron, Who Pays the Property Tax? 76 & n.9 (1975).

holding land from the market. The net result may simply be an exacerbation of sprawling development as new construction leapfrogs past the urban fringe. However, any attempt to impose a legal restriction on future development could prove unworkable and certainly inappropriate for an introductory property tax draft. Because owners of land ready for development in the urban fringe hold a valuable resource, it would be desirable to avoid extending tax preferences to this group. A compromise alternative requires repayment of the tax reduction enjoyed for a specified number of years before development occurs. There is no similar distinction between "current use" and "highest and best use" in the case of farmland located in agricultural areas that are not ready for urban development. Subsidies for these taxpayers are more likely to concern tax rates and exemptions for growing crops. Like other inventories, crops fluctuate in value throughout the year, and taxing them as of a specific date penalizes those farmers whose yield is at a maximum value at that time. Where profit from farm operations is subject to income taxation there is no need to include an arbitrary and unpopular assessment of crops in the property tax as well. A more difficult issue is presented by trees and other long-lived plants. A tax that includes improvements to land will have to specify whether such plants are included in the tax base.

4. *Area-Based Taxation*

A true area-based tax taking no account of differences in land value has the obvious drawback that "residents who own undesirable land must pay at the same effective rate as residents who own highly desirable land in a prime location with access to all services and amenities."[15] For this reason, property taxes based on area have generally been replaced by ad valorem measures, as in the Netherlands, or by a proliferation of special provisions designed indirectly to recognize gradations in value.[16] This latter situation negates the simplicity of application that is the prime recommendation for an area-based measure. Much simplicity can be retained without sacrificing the equitable benefits of a value-based tax through the use of zone and benchmark approximations of market value, discussed below.

5. *Acquisition Value*

In 1978 California voters amended the state's constitution to shift its property tax from one based on fair market value to one based roughly on acquisition cost. The actual California system uses a 1975–76 base-year value for

[15]Sandra Bettger et al., The Economic Impact of and Strategy for Implementing an Ad Valorem Property Tax: A Case Study of Krakow 7 (International City/County Management Association Report to the U.S. Agency for International Development 1994).

[16]Joan Youngman & Jane Malme, An International Survey of Taxes on Land and Buildings 157–73 (1994).

property that has not changed hands since that time,[17] a 2 percent maximum annual inflation adjustment,[18] and many provisions defining the type of change in ownership that leads to reassessment at market value.[19]

This unusual system has engendered strong political support and strong criticism. Its great benefit is its predictability, allowing a taxpayer purchasing property to calculate the level of future tax obligations with great accuracy. This is a direct response to California's rapid housing price inflation of the 1970s, when property tax bills increased sharply as local governments failed to reduce tax rates in proportion to the rising tax base. This predictability carries with it a concomitant simplicity of administration: values need only be assigned upon a change in ownership, which usually yields sales data as well.

These benefits are obtained at a heavy price. Particularly in a time of rapid price increases, acquisition costs can diverge sharply from market values and therefore from property wealth as an index of ability to pay. This tax base can confer a perverse reward on owners experiencing an increase in their net wealth while burdening newer purchasers who have paid a higher price for similar property. Alternatively, to the extent the increase in tax is capitalized, the burden may fall in part on the seller, but this is also capricious and creates a lock-in effect. An acquisition value base can provide a strong disincentive for changes in residences, penalizing those whose jobs or family situations require mobility.

It has been argued that, under this system, property will be revalued at least once every generation. In fact, California permits the acquisition value tax base for a home to be transferred between parents and children.[20] This greatly extends the potential duration of disparities in taxes faced by owners of similar properties and exacerbates the antimobility effects of an acquisition value base. Like many of the extensions of the California tax limitation measure, this was not part of the original legislation but was approved in a later popular election as an expression of antitax sentiment.

6. *Other Tax Bases*

Some form of enterprise value, going-concern value, or measure of business income is often found in the base of a tax on business property, even when the tax is nominally intended to reach only tangible property. Strictly speaking, a tax on land and building values should not include going-concern or enterprise values. The value of the immovable assets should be set at the amount a prospective purchaser would bid for those assets alone, not for the assets as part of an ongoing business. However, in practice it is not unusual to encoun-

[17]Cal. Rev. & Tax. Code §§ 50, 110.1 (West 1987).
[18]*See id.* § 619(f).
[19]Cal. Rev. & Tax. Code §§ 60–69.3 (West 1987 & Supp. 1995).
[20]*See* Cal. Rev. & Tax. Code § 63.1 (West Supp. 1995).

ter hybrid taxes that combine these elements of a property tax and an enterprise income tax, sometimes producing a result inferior to both.

After property taxes in California were severely curtailed in the 1970s, some of them were replaced by per-parcel taxes or flat fees for each property unit. Equivalent to a poll tax on property rather than on individuals, these flat fees serve as an equally crude basis for distributing the cost of community services, justified only when specific limitations or historical developments leave other alternatives even less desirable. They represent an alternative to property taxation as discussed in this chapter rather than a means of implementing it.

C. Special Assessments and Betterment Levies

Special assessments finance capital improvements through additional taxes on properties within the area that benefits from such investment. These present some questions not raised by recurrent taxes used for general revenue purposes, such as whether voter approval is to be required for this imposition and whether collections will be limited to the cost of the improvements. However, for most purposes they may be analyzed as a variety of property taxation, and many of the issues discussed in this chapter, particularly with regard to valuation, will arise in the drafting of legislation to implement special assessments as well.

D. Market Value Taxation in Developing Economies

A certain degree of circularity accompanies the process of establishing public claims on land and building values through annual taxation in the early stages of a transition to a new regime of property rights. The market data needed to estimate the sale value of properties that have not themselves recently changed hands in an arm's-length transaction will become available only after investors have made purchases in reliance on the existing system of property rights. Therefore, some alternate method of estimating the value base will be required in the initial stages of the tax, even if a more sophisticated approach is adopted after market data are more widely available. Estonia, for example, "has taken the bold step to base the new land tax on values, even though the lack of market information will make it necessary to decide models for market values until proper estimation can take place based on sales prices."[21]

[21]Danish National Survey and Cadastre, Land Taxation and Valuation in Estonia 29 (1993). "The factors that are used in valuation models are pollution, water supply, land quality, valuation factors, location, roads, etc." Jussi Palmu & Jaisa Vuorio, Defining of Suitable Value for Estonian Settlement Where As No Land Market Exists (Seminar on Taxes on Land and Buildings, sponsored by the Danish National Survey and Cadastre and the Estonian National Land Board, 1993). Similarly, factors such as utility service, transportation access, zoning, soil quality, and infrastructure entered a recent model valuation of land in Poland. The Price of Land in Poland (U.S. Agency for International Development, Office of Housing and Urban Programs Working Paper 1990).

Even when such data are available, a statutory formula based on objective criteria designed to approximate market value may be preferable, on grounds of certainty and ease of administration, to an explicit market value standard. For example, Chile bases property taxes upon a formulary "fiscal value" of land and buildings, rather than on their market value.[22] Land within a given zone is assigned a fiscal value reflecting sale transactions, soil quality, and development in the zone. Buildings are valued according to specific characteristics and size, reflecting construction costs in the Santiago area, with adjustments for other regions.[23] Buildings are depreciated at a constant yearly rate determined by the type of construction, but total depreciation is limited to 25 percent of the initial fiscal value.[24]

This approach avoids many complications inherent in determining the meaning of "market value" for properties that have not been the subject of recent sales. Computer-assisted mass appraisal can provide strong grounds for estimating the sale price of properties that share characteristics of many similar properties, such as apartment houses and single-family residences. Often, however, valuable property will be of a type not frequently bought and sold, for example, specialized manufacturing sites. In these cases, market value can be defined either literally to mean the actual amount for which the property could be sold to an unrelated party (a figure that may be well below both the value to the current owner and the depreciated reproduction cost) or as a cost-based figure reflecting the special value to the current owner (which contravenes the general rule of market-based assessment that governs the taxation of other property). Some problems of this type will arise under any approach to value-based taxation, but the special difficulties of determining market value may recommend use of a formulary alternative even after sufficient data are available for market prices to be utilized in valuing property directly.

Within the formulary approach, three variations merit special consideration. The first and least accurate index of market value considers only a very limited number of factors. In the case of agricultural land, the existence of detailed data on soil analysis and productivity may permit classification on this basis. For example, in Moldova the Ministry of Agriculture has developed tax valuation charts for all 40 regions (rayons) and for 4 cities, based on fertility measure and type of land: crop fields, forests, vineyards, hay fields, and pasture.[25] This classification does not reflect locational advantage, even though distance from markets could affect the value of land, and development potential may be more important to the value of land in the urban fringe than its agricultural productivity. A second type of index takes into account an ex-

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[22]Youngman & Malme, *supra* note 16, at 105, 110–11.

[23]*Id.* at 110–11.

[24]*Id.* at 110.

[25]Acte Normative privind impozitul funciar si modul de impozitare, 1994 (MDA). This approach provides no basis for estimating the market value of urban land.

panded but still limited and legislatively prescribed number of factors. Finally, the specification of these factors may be delegated to the administrative body responsible for valuation. Such delegation provides the greatest flexibility but also risks the greatest sacrifice of legislative oversight. Where appropriate, it can provide the readiest transition to full market value taxation as more price data become available.

E. Taxation *In Rem* or *In Personam*

Debate sometimes arises as to whether a tax on land and buildings is to be designed as one *in rem* or *in personam*, and what consequences follow from that distinction. Terming the tax *in rem* generally denotes consideration only of property characteristics, and not personal attributes of the owner, in the assessment process. Three particular consequences may be intended. First, assessments may name the property but not rely upon identification of the owner to establish tax liability; instead, publication may be deemed to notify all interested parties of this claim. A second consequence may be a corresponding absence of personal liability, remedy for nonpayment being limited to seizure and sale of the property itself. Finally, this approach may be intended to avoid considerations of the personal status of the owner in determining the amount of the tax.

There is no need to avoid combining the characteristics associated with *in personam* and *in rem* taxation. As an American jurist wrote, "[a]ll proceedings, like all rights, are really against persons."[26] The tax may be levied in the first instance upon the owner, while at the same time publication may put all other interested parties on notice that a default may jeopardize their property rights. In fact, such mixed enforcement measures may be highly desirable. Useful as it is to maintain the option of collection through seizure of the property and foreclosure of a tax lien, this is a cumbersome and draconian means of securing payment of what in many instances may be a relatively small sum. The availability of personal enforcement against the owner may actually increase compliance when seizure of a home is deemed undesirable or infeasible.

For these reasons, it is preferable to avoid any references to *in personam* or *in rem* taxation in legislation and regulations, addressing instead the specific liability and enforcement issues raised by this distinction. The taxing authority may be directed to draw up a tax roll, listing as liable for payment any person "owning, claiming, possessing or controlling"[27] an interest in the property on the lien date. Under such a rule, more than one person—for example, the

[26]Oliver Wendell Holmes writing for the Court *in* Tyler v. Judges of the Court of Registration, 55 N.E. 812, 814 (Mass. 1900).

[27]This language is taken from Cal. Rev. & Tax. Code § 405 (West 1987), but similar counterparts are found in many other statutes. For example, the Canadian Indian Act, § 83(1)(a), refers to persons "occupying, possessing or using" the property.

owner of a property and the lessee of the property—may be jointly and severally liable for the tax. Parties aware of this legal regime can be expected to allocate the tax liability among themselves by contract, as through a lease contract specifying that taxes are the responsibility of the owner. This provision in the contract would not, however, prevent the tax administration from collecting from the lessee; it merely specifies the lessee's contractual right against the owner for reimbursement of the tax if the lessee must pay it.

This flexible approach to a definition of the taxpayer differs from the more familiar method of specifying only one person as primarily liable for a tax, but its broad terms offer important administrative advantages. Initially, the tax administration will, according to its usual procedures, send only one tax bill for a particular property, normally to the owner. Only if the owner fails to pay will the tax administration seek to collect the tax from others who are made liable under the law. If both the owner and the lessee are made liable under the statute, then the tax administration will not be required to show that it had made the requisite effort to collect from the owner before being able to go after the lessee. If the statute specified that the lessee would be liable only if the owner failed to pay, then the lessee might be able to avoid the tax by arguing that the tax authority had not made a sufficient attempt to collect from the owner.

This hybrid of personal and *in rem* liability raises administrative issues that may require special attention if they are not adequately addressed by general taxation provisions. The first concerns notification procedures, particularly in two special cases: where multiple parties claim an interest in taxable property (as in a joint tenancy) and where no party does. Both illustrate the benefit of the *in rem* aspects of a mixed enforcement system. Where legal interests have been divided among a number of individuals or entities, it is not feasible to require the assessor to determine the proportionate shares for which each is responsible. Because the tax is a lien against the property, all persons are on notice that their interests may be eliminated by foreclosure if the tax is not paid in full. Of course, this approach must be carefully coordinated with the *in personam* aspects of the enforcement provisions if the owner of a small partial interest is not to be liable for seizure of other property or funds to pay the entire amount of the tax. In the case of property with no identified owner, some statutes provide that "such land may be assessed to 'unknown owner' or 'unknown owners.'"[28] Although this may be useful in establishing a lien, it is always preferable to identify a named party claiming an interest in the property. The situation of unknown owners must be distinguished from systems of communal land tenure with no private ownership.[29] Property taxation is appropriate under such a regime only if nonownership rights, such as long-

[28]Or. Rev. Stat. § 308.240(2) (1992).

[29]The property tax implications of communal ownership are discussed with regard to African personal taxes in Richard M. Bird, Taxing Agricultural Land in Developing Countries 57–63 (1974).

term or renewable rights of use, are to be considered property for purposes of the tax.[30]

The converse issue concerns identification of those parties who may contest an assessment—both in cases where multiple interests exist[31] and in those where no claimants are identified. In the former instance, it is important to avoid potential repetitive claims; in the latter, steps must be specified for clearing title or foreclosing the tax lien within a given period, to encourage return of the property to the tax rolls and to the market.

A very interesting procedural issue sometimes arises with regard to a taxpayer's ability to protest the underassessment or improper grant of an exemption to a neighboring property.[32] This issue rarely needs to be addressed in the initial legislation introducing the tax, but considering the issue may help focus discussion on the practical questions that will arise with implementation of the tax.

F. Defining the Unit

Per-unit exemptions and progressive rate structures require a determination as to which contiguous or related parcels will be considered as one for purposes of the tax. The complexity inherent in progressive rate structures limits their applicability, and only an explicit political decision can justify their administrative costs, particularly in the case of a new tax or an economy in transition.[33]

The *in rem* aspects of the tax are in conflict with progressive rates, particularly when assessment must proceed in the absence of conclusive ownership information. Progressive rate structures assume an individual's ability to pay to be proportionate to the value of all property owned, however divided into par-

[30]*See infra* sec. III.

[31]Sometimes tenants obligated by the terms of their lease to pay taxes have been found eligible to protest an assessment issued against the landlord as owner. *E.g.*, Ewing Township v. Mercer Paper Tube Corp., 8 New Jersey Tax 84 (1985); Riso v. Pottawattamie Board of Review, 362 N.W.2d 513 (Iowa 1985).

[32]*See generally* Annotation, Standing of One Taxpayer to Complain of Underassessment or Nonassessment of Property of Another for State or Local Taxation, 9 Am. L. Rep. 428 (4th ser. 1981). Massachusetts permits any ten taxpayers in a single district to bring a court action to determine the legality of public actions to raise funds, expend money, or incur obligations. Mass. General laws, ch. 40, sec. 53. In Cabot v. Assessors of Boston, 138 N.E.2d 618 (Mass. 1956), *appeal dismissed*, 354 U.S. 907 (1957), a group of owners of parking garages located near Boston Common invoked this provision to protest the exemption of a portion of the property below the common leased to a private party for use as a commercial garage.

[33]Taiwan Province of China and Korea provide examples of highly developed progressive property tax systems. "When the various aspects of this question are seriously considered, it seems that the case for progression far outweighs the advantage of administrative simplicity of a flat rate." John Riew, *Property Taxation in Taiwan: Merits, Issues and Options*, 68 Industry of Free China 13 (1987).

cels or among different tax jurisdictions. Even under a flat-rate tax, some parcel definition may be required if exemptions are designed to remove low-value parcels or structures from the tax base. Otherwise, these exemptions may be expanded by artificial subdivision of single parcels into multiple units. Simplification is always best served by minimizing exemptions and avoiding progressive rate structures.

Another aspect of parcel identification concerns structures under construction or destruction. It is desirable that buildings under construction be assessed according to their state of completion at the time of valuation. The alternative of exempting such property until completion risks long-term tax evasion through deliberate noncompletion. Sometimes plans are deliberately drawn for large multistory buildings when only small structures are actually contemplated, solely to avoid taxation. Although property may produce no income until completion, it is not without value, and the property tax is not limited to income-generating assets. Similarly, buildings destroyed by fire or other cause during the tax year should be taxed as of their status on the valuation date, with such hardship relief as is contained in general administrative (or even nontax) provisions. A prorated property tax refund will rarely be the most effective means of disaster assistance.

G. Exemptions

Exemptions present a particularly dramatic example of the interplay among economic, legal, and political factors in the development of property tax systems. Typically, an array of complex provisions reflects the perceived social benefits of subsidizing particular property uses and owners. At the same time, considerations of economic neutrality and administrative efficiency recommend that exemptions be as few as possible.

Among the most common exemptions are those granted to property owned by charitable organizations. It is important to consider the commercial use of property that will negate the exemption and the effect of division of interests in property between charitable and noncharitable uses and owners. Many practical issues also arise with regard to the status of uses that are not charitable in themselves but are ancillary to an exempt purpose, such as parking lots and administrative offices. Often, such determinations will be too detailed and factual for consideration in the statute itself, but it is important that they be addressed explicitly, whether by decree or by regulation.

Where feasible, a charge in lieu of a tax on exempt property can serve both land use and revenue functions by reflecting the cost of property-related services, particularly if this amount is set as some proportion of the tax that would be due absent the exemption.

The taxpayer claiming the exemption should be required to file appropriate documents establishing the exempt status of the property. In practice,

such filings are sometimes required annually and sometimes only on a change in status.[34]

III. Property Rights and Valuation

A. What Is "Ownership"?

A legal view of property as a set of intangible rights raises a question as to which rights are being valued for tax purposes.[35] While the physical dimensions of a parcel of land or of a building may be objectively established, this does not determine which rights constitute a property interest in those physical elements. Two particularly important issues concern the extent to which restrictions on the owner's use or enjoyment are to be considered in assessment and the manner in which partial interests are to be taxed.

All property rights are subject to some restrictions that may affect market value, whether in the form of building codes, zoning, health and safety regulations, environmental protection or remediation measures, rent control, or other publicly imposed limitations on use. In addition, a wide array of privately negotiated provisions, such as leaseholds, easements, and restrictive covenants, may diminish or redistribute the value of the original undivided interest.

Public legislation that has reduced the value of an owner's interest may be considered part of the overall legal structure of property rights within which the valuation is to take place. Private agreements stand on a different footing. Permitting these to reduce taxable value runs a clear risk of encouraging non-arm's-length agreements, such as disadvantageous leases designed solely to lower property assessments. Even legitimate, profit-motivated agreements need not be allowed to reduce the tax base if owners are on notice before concluding them that tax liabilities will remain unchanged if the contract reduces the market value of their holdings. Actions that reduce property value (such as failure to modernize or maintain a building) must, however, be clearly distinguished from those that redistribute that value (such as a disadvantageous lease, which increases the value of the tenant's interest even as it reduces the value of the landlord's position). Disregarding the former actions violates the goal of taxing property values and risks unverifiable and subjective valuations. Disregarding the latter, however, simply effectuates the aim of taxing all private interests in property. It is equivalent to requiring only a single assessment of property held by joint tenants.

[34]*See, e.g.*, Cal. Rev. & Tax. Code § 254 (West 1987) (colleges, libraries, and museums required to file annually); *id.* §257(c) (religious institutions required to file only when exemption is first established).

[35]It is important to consider this point within the context of existing property law. Civil law systems, for example, are more likely to consider "ownership" indivisible than are common law countries. *See* John Merryman, *Ownership and Estate*, 48 Tulane L. Rev. 916 (1974).

An owner who conveys property rights to another party has clearly diminished the sale value of his or her remaining interest. For example, property encumbered by rights of access or limitations on building will not command as high a market price as it would in the absence of these provisions. Many legal disputes have arisen with regard to the property tax treatment of such encumbered property. On the one hand, assessors generally disregard most private and voluntary divisions of interests to avoid the administrative difficulties of dividing property value among lessors, lessees, mortgagors, mortgagees, life tenants, holders of a remainder interest, and other holders of property interests. This result is fair as long as parties to these agreements are on notice that it is their own responsibility to allocate an undivided tax bill among themselves. On the other hand, certain interests in property, primarily easements, will affect the value of other taxable parcels, and it is important that the tax treatment of the two properties be consistent. For these purposes, an easement may be considered any partial, nonpossessory interest in property, such as a right of way over it or a right to prevent construction upon it. If the easement is ignored in the assessment of the property whose value it diminishes, it should not be allowed to raise the assessment of the property whose value it enhances.

An early case addressing this issue[36] dealt with the assessment of Gramercy Park in New York City, a private park laid out in 1831 by Samuel Ruggles, a real estate developer who then sold 66 building lots on the perimeter of the park. The purchasers of those lots received rights to the park and keys to its gates, an arrangement that continues to the present day. The trustees holding title to the park argued successfully in court that the park itself had no market value in its encumbered state and that its value had been transferred to the adjoining lots. Although this result avoids inconsistency, it may encourage tax-motivated encumbrances. Land-use agreements may raise, lower, or leave unchanged the value of all affected parcels; there is no necessary conservation of taxable value when private arrangements of this type are permitted to determine property assessments.

One area of current interest with regard to taxation of restricted property concerns conservation easements, which prohibit or restrict development on environmentally sensitive land through an agreement between the landowner and a conservation organization or governmental institution. Although the land remains in private ownership, its market value may be greatly reduced by such an arrangement. Unlike the appurtenant easement, a conservation easement does not transfer rights to neighboring landowners, leaving the *Gramercy Park* rationale inapplicable. However, the development rights might be viewed as property interests held for charitable purposes by a tax-exempt organization. If charitable interests held for charitable purposes are generally ex-

[36]People *ex rel.* Poor v. O'Donnel, 124 N.Y.S. 36, *aff'd mem. sub nom.* People *ex rel.* Poor v. Wells, 93 N.E. 1129 (N.Y. 1910).

empt from property tax, then there would be an argument by analogy for taking the easement into account in valuation. In the United States, some states have addressed this problem directly by statute; in others, it has been left to the courts to determine according to general principles of property tax law. Both approaches have produced a range of results.[37]

Where ownership rights are uncertain or in the process of being established, the *in rem* attributes of a property tax may permit assessment against the property itself. All persons with interests in the property are then on notice to arrange for payment in order to protect their rights. This could permit a tax system to begin operation and to become an element in purchasers' bids and in contract negotiations, even before property owners are registered or identified. The absence of a designated owner may also give rise to multiple claims to property, but it is unlikely that these would be avoided by delaying imposition of the tax. In fact, it may encourage payment of the tax by those who hope to use this to buttress their claims to ownership in the event of a later challenge.

B. Property Rights and Tax Liability

The problem of divided legal interests in property raises a question as to whether interests that do not rise to the level of ownership may be subject to taxation. In some property tax systems, they may. In the United States, claim of a right to use charitable or public property for profit may potentially leave the holder liable for property tax on that interest or even on the value of the full, undivided property.[38] However, the perceived unfairness of this result has prevented states and localities from exercising this power broadly.[39] It is more important that a new tax specify precisely when partial interests in otherwise exempt land or buildings will themselves be taxable. Examples may include grazing rights on public land, concessions and restaurants in public parks, and

[37] *E.g.*, Idaho Code § 55-2109 (1994): "The granting of a conservation easement across a piece of property shall not have an effect on the market value of property for ad valorem tax purposes, and when the property is assessed for ad valorem purposes, the market value shall be computed as if the conservation easement did not exist." Village of Ridgewood v. The Bolger Foundation, 517 A.2d 135 (N.J. 1986) (finding conservation easement to reduce property value).

[38] United States v. City of Detroit, 355 U.S. 466 (1958).

[39] The harshness of this result may be debated in specific cases. For example, it could be argued that a lessee with the right to occupy the property for the full taxable year should be responsible for the full property tax that year. A dissenting opinion in one U.S. case wrote, "[t]he single, the most important incident of ownership of industrial goods is possession *and the right to use them in a business conducted for profit*. That right is coextensive with other forms of ownership if it is borne in mind that the tax covers but a one-year period." Continental Motors Corp. v. Township of Muskegon, 135 N.W.2d 908, 915 (Mich. 1965) (Adams, J., dissenting). The alternate perspective would allocate the market value of the entire property between the value of the tenancy and the value of the remainder and base the respective tax liabilities of the tenant and the (possibly exempt) landlord on that division.

commercial activities of religious, educational, or charitable institutions. If no tax is due on property owned by an exempt organization but leased for a commercial use, the exempt lessor will simply be able to command higher net rents than are available to its private competitors.

C. Valuation of Land and Buildings

Different tax rates for land and buildings can raise many complex issues as to the allocation of value between the two, because sales data will generally reflect transactions in which the land and the structures upon it were sold as a unit. In some legal systems, it is possible to convey ownership or rights of use in a building without rights in the underlying land. In reality, any use of the building, including moving it to a different location, requires some use of the underlying land. The right to keep the building in a particular location implies surrender of all alternate uses of the land. The converse, a transfer of rights to land without any rights to the structures located on it, suffers from similar artificiality. From this perspective, the land and building constitute two integral components of a larger entity whose value cannot be divided in a meaningful way. In his 1937 treatise on property valuation, Professor James Bonbright wrote

> [a]lthough a separate valuation of land and of improvements is called for by many of the statutes as well as by the practice of assessors, the fictitious nature of this separation is apparent. . . . The attempt to do so would result in the same error that would be committed were we to seek the value of Raphael's Sistine Madonna by adding the separate value of the lower half of the canvas to the separate value of the upper half.[40]

Conundrums of this type can be avoided by specifying that land values are to be based upon sale prices of comparable unimproved land. Building values may then be specified either as the residual of the combined land and building value or as the product of a formulary approach such as construction cost of a new building less depreciation.

IV. Legal Issues in Setting the Tax Rate

A. Use of Assessment Ratios

Some tax rates are set by a two-step process in which a fractional assessment ratio is first applied to property value and a tax rate is then imposed on the resulting figure. This results in a distinction between the nominal tax rate (the specified rate applied against the diminished value) and the effective tax rate (the proportion of full value represented by the tax; the product of the assessment ratio and the nominal tax rate). In some cases, this may be a neces-

[40]James Bonbright, 1 The Valuation of Property 485 (1937).

sary response to special legislative or political constraints. Where a nominal rate must be set by law and can be changed only rarely or with difficulty, there may be reasons for administrative discretion to vary the effective rate in this way. Absent an unusual situation of this type, it is far preferable to determine the tax by applying a specified rate to full market value. Because assessment ratios diminish taxpayers' ability to understand and challenge their assessments, "extralegal" fractional systems often develop as a means of reducing taxpayer protests by concealing the relationship between assessed values and tax bills. There are no grounds for establishing such a situation if extraneous factors do not require it.

B. Responsibility for Setting Tax Rates

The status of the property tax as a central or a local levy will affect the assignment of responsibility for setting tax rates. Where the tax will function as an autonomous local revenue source, it is possible to allow local governments to set rates, or to set them within bounds established by the central government. Over thirty years ago, Ursula Hicks wrote the following:

> If local bodies are to play any significant part in economic or social development, they must clearly have access to adequate finance. If they are both to act responsibly and to show initiative, some, not negligible, part of this control over resources must be independent, in the sense that the local councils are free to choose the rates (and to some extent the conditions) of their taxes or service charges.[41]

Some local governments will be limited by their administrative capacity and competence as to the autonomy they can responsibly exercise with regard to revenue. Debate on this point is by no means restricted to newly formed local governments or to economies in transition. The past two decades have seen many initiatives in the United States and the United Kingdom to curtail local control over tax rates. In particular, the nationalization of business rates in the United Kingdom reflected suspicion that local governments sought to place an undue tax burden on nonvoting property owners. A 1986 Green Paper stated: "There is no voting right attached to the payment of non-domestic rates [i.e., business property taxes]. However much a business might contribute to the income of a local authority, it cannot exercise any direct electoral influence over local taxation decisions that can affect its competitiveness and its scope for investment."[42]

Actual rates of tax vary widely in international practice, and a lack of reliable data on assessment practices prevents ready translation of reported nominal rates to effective levels. For example, in Boston, Massachusetts, the

[41]Ursula Hicks, Development from Below: Local Government and Finance in Developing Countries of the Commonwealth 277 (1961).

[42]Parliamentary Green Paper, Paying for Local Government, 1986, Cmnd 9714, at 14.

nominal rate was 25 percent before the property tax was reformed in the late 1970s; however, this represented a far lower effective rate based on current market values because assessed values—with some exceptions—generally tended to be a very low percentage of full market value.

V. Administrative Issues

A. Assignment of Responsibility

The tension between the goals of local autonomy and central control, particularly where local administrative capacity may be lacking and central government resources overstretched, will require special attention in dividing responsibility for tax administration. One alternative allows local responsibility subject to oversight by the central government. In a typical example of legislative language addressing this point, the Massachusetts statutes provide that the state Commissioner of Revenue shall set forth "rules, regulations and guidelines" for assessment, develop forms, and conduct mandatory training programs for local tax officials.[43] Another possibility is to divide property into categories assigned to local tax administration, such as residential and commercial property, while the central government values and assesses complex properties and those spanning multiple jurisdictions, such as public utility property, railroads, and pipelines.

If administrative responsibilities with regard to the tax are shared between two or more levels of government, it is important to provide each with a share of collections at least sufficient to cover its costs and to specify how any refunds later found owing are to be financed.

Although not necessarily addressed in property tax legislation itself, the treatment of the property tax for purposes of income taxes or other central government levies is an extremely important aspect of intergovernmental fiscal relations.[44] In effect, a deduction or credit serves as a central government subvention to local authorities. Such transfers have been praised as supporting autonomous local government and appropriately recognizing the diminished ability to pay resulting from local tax liabilities. They have also been criticized as hidden subsidies for free-spending localities and deductions for payments that are equivalent to personal consumption, funding as they do local amenities and services rather than large-scale transfer payments and national programs.[45] These are political issues that cannot be resolved by tax legislation, but that must be taken into account in its drafting.

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[43]Mass. Ann. Laws ch. 58, §§ 1–3 (Law. Co-op. 1990).

[44]*See supra* ch. 2, sec. V(B)(6).

[45]*See, e.g.*, U.S. Treas. Dept., The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity: General Explanation 62–64 (1985).

B. Enforcement and Liens

One frequently mentioned advantage of property taxation is the immovable nature of the asset securing its payment. A lien upon land and buildings serves to assure the taxing authority of eventual payment; at some point, a purchaser will require unencumbered title and the outstanding tax liability will be met.

In the absence of the drastic step of foreclosure and sale of the property, a lien itself may or may not be a powerful enforcement tool. Owners who are preparing to sell may be motivated to lift this cloud on their title and may also have the cash with which to do so, but the lien may have little effect on others. Foreclosing the lien and selling the property, particularly when it constitutes the residence of poor or middle-class taxpayers, may have unacceptable political consequences, which will be exacerbated if the tax represents a small percentage of the value of the property seized. This weakness of liens recommends a combined approach: the option of foreclosure and auction, which can be exercised in a few well-publicized instances of flagrant tax evasion, together with the alternative of personal remedies, such as fines and attachment of assets other than the property itself. It is particularly important to apply a market interest rate to outstanding liabilities if interest on unpaid tax is not addressed in the general tax law.[46]

C. Revaluation Cycles

Ideally, all information affecting the property tax base would be taken into account in an annual assessment process. However, a complete revision of the valuation or formulary basis of the tax may be feasible only on a periodic cycle. It is far preferable to establish a multiyear cycle, possibly with interim provisions for indexing values for inflation, than to allow an unrealistic goal of annual valuation to be ignored. Taxpayer reliance upon inaccurate assessments that, over time, are capitalized into land and building prices can prove an almost insurmountable political obstacle to revaluation. This was a major reason for the failure of domestic rates in the United Kingdom, where the law required a reassessment every five years but where none had been undertaken in England and Wales since 1973.[47]

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[46] *See supra* ch. 4, sec. II(J).

[47] *See* Peter G. Richards, *The Recent History of Local Fiscal Reform, in* The Reform of Local Government Finance in Britain 28 (Stephen J. Bailey & Ronan Paddison eds., 1988). In 1986, legislation was passed to implement the Community Charge or "poll tax" in Scotland in 1989. Similar legislation passed in 1988 implemented the Community Charge in England and Wales in 1990. *See* David Butler et al., Failure in British Government: The Politics of the Poll Tax (1994), App. 1. "A revaluation of all rated property might have caused an eruption, given the relative increase in the value of property in the south-east since the previous valuation in 1973." *Id.* at 61.

If a cyclical system is instituted, it is desirable to address directly the issue known as "spot assessment," that is, revision of one assessment to reflect increases in market value, as upon a recent sale, when other parcels in the jurisdiction are not similarly revalued. If it is practical to keep valuations reasonably up to date, it would not be unfair to utilize new information of this type. More commonly, whatever cycle is permitted as the maximum interim between revaluations becomes the norm; if more frequent individual changes are allowed, partiality and inequity may result.

VI. Checklist of Issues for Legislative Drafting

The preceding discussion has identified a number of items to be clarified in establishing a new legislative approach to property taxation. These may be summarized as follows:

A. Scope of the Tax

- What kinds of property are to be subject to this tax? Alternatives discussed here have included all property, all tangible property, land and buildings, land alone, and unimproved site value alone.
- How does the definition of property in the taxing statute coordinate with the property law of the jurisdiction? For example, are mineral rights to be taxed to the owner of the surface land?
- How is property to be identified? Is this identification coordinated with the work of other government agencies, such as title or deed registries, cadastres, and mapping offices?
- How is an individual parcel to be identified if progressive rates or per-parcel exemptions require such identification?

B. Identification of the Taxpayer

- Is the taxpayer a person standing in a particular relation to the property, such as the owner or occupier? The alternative, *in rem* approach gives public notice of the outstanding amount and requires all parties interested in the property to arrange among themselves for its payment.
- How is tax liability allocated among multiple parties holding partial interests in a single property?

C. Exemptions

- What specific types of property are to be exempt? Examples include charitable, religious, and educational property.
- Does the exemption stem from ownership of the property by a specific type of organization or from its active use in furtherance of an exempt purpose?

- Are governmental properties exempt? If so, is this exemption limited to property held by the level of government imposing the tax? Do treaty obligations or other agreements require that properties held by foreign governments or international organizations be exempt?
- Is the burden of establishing the exemption on the property holder?
- Must the exemption be reviewed or renewed periodically?
- How are commercial uses of exempt property treated for tax purposes?
- What is the tax liability of private persons holding partial interests in otherwise exempt property?

D. Concessions and Preferential Assessments

- Are there specific concessions for special groups, such as low-income, handicapped, or elderly taxpayers?
- Do these concessions take the form of a reduction in the tax or an extension of the time within which to pay it?
- Do specific types of property, such as farmland, forestland, or residential buildings, qualify for special assessment procedures? Are growing crops and forests subject to taxation?

E. Measurement of the Tax Base

- Is the tax based on a market-value measure? Alternatives discussed here have included formulary computations, an area base, acquisition cost, and per-parcel fees.
- If the tax is based on market value, is this capital value or annual value?
- If the tax is based on a formula designed to approximate market value, what provisions have been made for periodic review and revision of the formula as more market data become available?
- What is to be the assessment of property under construction as of the valuation date? Of property destroyed after the valuation date but before the close of the tax year?

F. Setting the Tax Rate

- What level of government is responsible for setting the tax rate?
- May the rate vary annually? If so, within what limits?
- Do other elements in addition to the tax base and rate (e.g., assessment ratios) enter the tax calculation?

G. Intergovernmental Issues

- How is responsibility assigned for assessment, collection, oversight, and regulation?

- How are tax collections to be divided among levels of government?
- Is any portion of tax collections earmarked for specific purposes?
- Will payment of the tax give rise to a deduction or credit for purposes of other taxes?
- What level of government bears the burden of reduced collections as a result of exemptions and concessions?
- Are values assigned to property for purposes of this tax coordinated with values used for other tax purposes, such as eminent domain (compulsory purchase) awards and calculation of capital gains?

H. Procedural Issues

- Are specific collection procedures or collection points called for by this tax?
- What is the required or permitted frequency of revaluations?
- May individual parcels be revalued in the absence of a general revaluation?
- What procedure governs tax appeals?

I. Collection and Enforcement

- Do unpaid taxes give rise to a lien upon the property? If so, what steps are required for foreclosure and sale?
- What is the priority of such a lien? Does a foreclosure sale convey a new and clear title?
- Does the lien arise as of the date of assessment or at another time?
- May recourse for unpaid taxes be had against the taxpayer personally, with seizure of other property, to satisfy this obligation?
- How is liability for tax payment allocated when multiple parties hold partial interests in the same property?

10

Taxation of Wealth

Rebecca S. Rudnick and Richard K. Gordon

> It is not righteousness that you turn your faces toward the East and West, but righteousness is that one should believe in God and the last day and the angels and the Book and the prophets, and give away wealth out of love for Him to the near of kin, and the orphans, and the needy, and the wayfarer, and the beggars, and the captives, and keep up prayer and pay the poor-rate. . . .
>
> —*The Qur'an, Surah II 177*

I. Introduction

Two major types of taxes are levied on wealth: those applied sporadically or periodically on a person's wealth (net wealth taxes), and those applied on a transfer of wealth (transfer taxes).[1] Net wealth taxes are typically assessed on the net value of the taxpayer's taxable assets (i.e., value of assets minus any related liability), either sporadically (often known as "capital levies") or on an annual or other periodic basis.[2] Transfer taxes, which are typically assessed on the net value of the taxable assets transferred, fall into two basic categories: those levied on the transferor or her or his estate (more typical in common law countries), and those levied on the recipient.[3]

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[1]On the distinction between the two, *see* Dennis Kessler & Pierre Pestieau, *The Taxation of Wealth in the EEC: Facts and Trends*, 17 Canadian Public Policy 309, 309–10 (1991).

[2]*See* Alan A. Tait, The Taxation of Personal Wealth 70 (1967).

[3]*See* Jack M. Mintz, *The Taxation of Personal Wealth in International Perspective*, 17 Canadian Public Policy 248, 250–51 (1991).

Table 1. Wealth Taxes

Form	Examples
Net Wealth Tax	Periodic Sporadic (capital levy)
Transfer Tax	
Transferor-based	Estate tax, gift tax, unified tax
Recipient-based	Inheritance tax, gift tax, accessions tax

Transferor-based taxes can be levied separately on inter vivos transfers (gift tax) and on transfers at death (estate tax), or together in a single integrated tax.[4] Recipient-based taxes can also be levied on inter vivos transfers (gift tax), on transfers at death (inheritance tax), and on an integrated basis (accessions tax). Other taxes relating to property and wealth that are not levied on a net basis are not discussed in this chapter.[5]

Generally, the tax base for taxes on wealth can include either the worldwide net assets owned by, transferred to, received (depending on the type of tax), or given away by a taxpayer who has a sufficient connection with the jurisdiction, or those assets situated in a jurisdiction regardless of the taxpayer's connection with it.

Taxes on wealth are typically applied at graduated rates.[6] The applicable rates for net wealth taxes may be determined by the wealth of the taxpayer alone or may involve aggregation of the wealth of members of a family. The rate of those transfer taxes levied on the transferor is typically based on the cumulative amount transferred by gift, bequest, or both, although some exemp-

[4]*See* Tait, *supra* note 2, at 137–40. The former U.K. Capital Transfer Tax, which was in effect from 1975 to 1986, was levied on a cumulative basis on all transfers during lifetime and at death. *See* M.R. Moore, *United Kingdom Inheritance Tax*, 34 European Taxation 421 (1994). An integrated tax was established in the United States in 1976. *See generally* Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 525–32 (1976). The U.S. tax is still in effect.

[5]Taxes on immovable property are sometimes described as a type of wealth tax; these taxes are discussed in ch. 9. Assets taxes serving as a minimum income tax are discussed in ch. 12. A number of miscellaneous taxes are also sometimes described as forms of wealth taxes, such as taxes on some types of personal property (such as automobile excise taxes), or stamp duties on registration of deeds to immovable property. However, each of these taxes is typically applied to the gross value of assets, without accounting for any liabilities. Hence, they are not taxes whose base is measured on a *net* basis and are not covered here. Capital transfers may also give rise to income tax or value-added tax (VAT) liability; these issues are discussed in chs. 6 and 7 and, in vol. 2, chs. 14 and 16.

[6]Wealth taxes often have an exempt amount, or an amount that is taxed at the rate of 0 percent. Such wealth taxes, even if they have only a single positive rate, actually have two rates, thereby resulting in a progressive rate schedule. *Cf.* vol. 2, ch. 14 (discussion of progressive rate schedule for income tax). For example, in Germany physical persons are subject to only a single rate of tax, at 0.5 percent. DEU VStG art. 10(1)1. However, various tax-free amounts result in a 0 percent rate for those tax-free amounts. DEU VStG art. 6.

tions are based on relationship to the transferee.[7] The rate of taxes levied on the recipient is typically based both on the amount received by each separate recipient and on the relationship of the recipient to the transferor.[8]

The distinction between transferor-based and recipient-based taxes is not black and white. In the case of transferor-based taxes, the existence of various exemptions, exclusions, and deductions based on the status of the recipient can make the tax liability similar to that under a recipient-based tax. In the case of a recipient-based tax, administrative techniques of collecting the tax at the level of the transferor can make it procedurally similar to a transferor-based tax. Therefore, the listing of forms of wealth tax in Table 1 should not be seen as necessarily presenting sharp dichotomies in the operation of these taxes.

Taxes on wealth are in effect in most developed countries, although wealth transfer taxes are more common than net wealth taxes.[9] A number of developing and transition countries also have either a net wealth tax or a transfer tax, or both.[10] Over the past 25 years, a few countries, both developed and developing, have repealed their wealth transfer taxes.[11]

A. Tax Capacity

1. *Wealth Taxes in General*

"Taxes on wealth," writes the public finance economist Richard Bird, ". . . are among the oldest fiscal instruments in most countries. . . . [But] [d]espite their antiquity, wealth taxation has been relatively neglected in recent

[7]*See, e.g.*, USA IRC § 2001(c)(1). However, unlike most transferor-based tax systems, the United Kingdom has only a few rates, 0 percent on an exempt amount, 20 percent for *inter vivos* transfers, and 40 percent on testamentary transfers, with a sliding scale if death takes place in the fourth, fifth, or sixth year following an *inter vivos* transfer. *See* Moore, *United Kingdom Inheritance Tax*, *supra* note 4, at 424.

[8]*See, e.g.*, FRA CGI art. 777 (rates ranging from 5 to 60 percent depending on amounts and degree of relationship between transferor (deceased) and transferee (heir or assignee)).

[9]For example, among the EU, the United States, and Japan, only Austria, Denmark, Finland, France, Germany, Luxembourg, the Netherlands, Spain, and Sweden have net wealth taxes, while all have wealth transfer taxes. Organization for Economic Cooperation and Development [OECD], Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals tbl. 0.1, and ¶ 1.1 (1988). Canada, however, has a net wealth tax but no wealth transfer tax. *Id.*

[10]For example, India, Pakistan, and Vietnam have net wealth taxes but not wealth transfer taxes, while Bulgaria, the Czech Republic, Hungary, Montenegro, the Philippines, Russia, Romania, and Serbia have wealth transfer taxes but not net wealth taxes; Slovenia has both, while South Africa and Turkey have wealth transfer taxes and have recently had onetime net wealth taxes. *See, e.g.*, CZE IHT, PHL NIRC, RUS IHT, SVN TC.

[11]Including Argentina, Australia, Canada, India, Israel, Mexico, New Zealand, Pakistan, and Sri Lanka. *See* International Bureau of Fiscal Documentation, Taxes and Investment in Asia and the Pacific (1994). For a review of wealth transfer taxation in developing countries, *see* Bernadette T. Davey, *Gift and Inheritance Taxes in the African Continent*, 39 Bull. for Int'l Fiscal Documentation 123 (1985); M.A. Ga. Caballero, *Latin America: Taxation of Gifts and Inheritances, a Practical Approach*, 39 Bull. for Int'l Fiscal Documentation 55 (1985).

years."[12] Development economists were once very interested in the possible benefits of taxes on wealth. Lord Kaldor recommended the enactment of wealth taxes in developing countries, reflecting his belief that the holders of substantial economic resources in developing countries had the capacity to pay higher taxes than those with similar incomes but with less wealth.[13] Wealth tax advocates have argued that a tax on income does not by itself take into account the claim on overall resources that wealth confers. There is, for example, a difference in ability to pay between a person who has $20,000 in annual income from a $200,000 investment, and a person who earns $20,000 a year from her or his labor.[14]

Other tax theorists have suggested that addressing the additional tax capacity afforded by wealth could allow top marginal income tax rates to be reduced without sacrificing overall tax progressivity. In the alternative, a wealth tax may add to the overall progressivity of an income tax without having to increase marginal rates.[15] A wealth tax could also assist the administration of other taxes, providing information to collect income taxes and property taxes.

[12]Richard M. Bird, Tax Policy and Economic Development 130 (1992).

[13]Nicholas Kaldor, Indian Tax Reform 19-28 (1956); Nicholas Kaldor, Suggestions for a Comprehensive Reform of Direct Taxation 13–14 (1960).

[14]This example is taken from Richard Goode, Government Finance in Developing Countries 133 (1984).

[15]The progressivity effects of wealth taxes have been the subject of much scholarly debate, most particularly in the United States. In that country, before the considerable increase in reliance on the income tax as a revenue source during the Second World War, the estate tax provided up to half the amount of revenue yielded by the income tax, contributing substantially to the progressivity of federal taxation. *See* John E. Donaldson, *The Future of Transfer Taxation: Repeal, Restructuring, and Refinement, or Replacement*, 50 Wash. & Lee L. Rev. 539, 544 (1993). By the 1980s, the relative amount of contribution to total revenues by the estate tax had declined dramatically. *Id.* In 1994, estate and gift tax revenue represented 1.2 percent of federal revenue ($15.2 billion) in the United States. According to one scholar, the drop in estate tax yield in the United States has ensured that the estate tax no longer materially contributes to the progressivity of the federal tax system. *Id. See also* Joel C. Dobris, *A Brief for the Abolition of All Transfer Taxes*, 35 Syracuse L. Rev. 1215 (1984). In France, the wealth tax (*l'impôt de solidarité sur la fortune*) yields F 9 billion out of total revenue of F 1,400 billion. *See* Le Monde, April 21–22, 1996, at 6. According to one study, no country currently derives significant revenues from taxation of wealth. Henry J. Aaron & Alicia H. Munnell, *Reassessing the Role for Wealth Transfer Taxes*, 45 Nat'l Tax J. 121, 133 (1992). *See also* OECD, *supra* note 9, ¶¶ 0.21–0.22 (1988). In the words of another American scholar, "a strong wealth transfer tax system runs counter to deep-seated human motivations," making it unlikely that any jurisdiction would ever enact a wealth tax with sufficient revenue implications to add significantly to progressivity. Edward J. McCaffery, *The Uneasy Case for Wealth Taxation*, 104 Yale L. J. 283, 294 (1994). *See also* Charles O. Galvin, *To Bury the Estate Tax, Not to Praise It*, 52 Tax Notes 1413 (1991), who argues that changes to the income tax can make up for any loss of revenue (or progressivity) from the repeal of a wealth tax. However, others have argued that, while a wealth tax does not make a major contribution to progressivity, it can make some contribution. *See, e.g.*, Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 Yale L. J. 259, 271 (1983). Commentators from other countries have also pointed out difficulties with wealth taxation. *See, e.g.*, Klaus Tipke, Die Steuerrechtsordnung 768–808 (1993); Gunnarsson, Skatter Ettvisa 29 (University of Uppsala doctoral thesis,

A wealth tax base separate from an income tax base can help ensure that taxes not collected on the latter, because of avoidance or evasion, might be collected on the former.[16] This may be particularly true with regard to income from asset appreciation that has accrued but that is not taxed owing to the "realization event" nature of most income tax systems.[17] While a net wealth tax would by no means be an equal substitute for an accrual-based system of income taxation, it might at least help capture some additional revenues from appreciated assets.

2. *Wealth Transfer Taxes*

Wealth transfer taxes can also be viewed as complements to an income tax.[18] An income tax by itself does not tax wealth, only accretions to wealth. In virtually all income tax systems, gifts and bequests are not taxed as income to the recipient.[19] There are a number of reasons for this exclusion, including problems of income averaging. Assuming that gifts and bequests are not included in the income tax base, a separate wealth transfer tax can serve as a surrogate to such inclusion.[20]

1995) ("Today, however, circumstances are such that, in principle, all those forms of ability to pay tax which are founded on the net wealth, yield, funded earned income, ability to consume, and different kinds of wealth transfers, are being taxed in other forms than by a net wealth tax. Hence, there is no room for justifying the net wealth tax with the support of the theory of ability to pay tax."). For a general discussion of the use of wealth taxation to provide for equality, *see* Edward N. Wolff, Top Heavy: A Study of the Increasing Inequality of Wealth in America (Twentieth Century Fund Report, 1995).

[16] *See, e.g.*, Harry L. Gutman, *Reforming Federal Wealth Transfer Taxes after ERTA*, 69 Va. L. Rev. 1183, 1185–86, 1189–97 (1983); Henry J. Aaron & Harvey Galper, *A Tax on Consumption, Gifts, and Bequests and Other Strategies for Reform*, in Options for Tax Reform 106, 111–12 (Joseph A. Pechman ed., 1984).

[17] *See* Paul B. Stephan III, *Commentary: A Comment on Transfer Tax Reform*, 72 Va. L. Rev. 1471, 1479 (1986).

[18] *See* Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 Yale L. J. 1081, 1112–14 (1980).

[19] Some scholars have argued that gratuitous transfers should be excluded from the income tax base of the recipient. Michael McIntyre & Oliver Oldman, *Taxation of the Family in a Comprehensive and Simplified Income Tax*, 90 Harv. L. Rev. 1573, 1577 (1977). Henry Simons, however, argued that, as changes occur in the recipient's net worth, gifts and bequests should be included. Henry Simons, Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy 50, 56–58, 125–47 (1938). *See also* Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45, 68–69 (1990). *See generally* Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 Harv. L. Rev. 1177 (1978).

[20] However, most accessions tax proposals do not aggregate accessions with other income, only with other accessions. *See* William D. Andrews, *The Accessions Tax Proposal*, 22 Tax L. Rev. 589, 591–93 (1967). Japan following the Shoup Commission Report in the 1940s, *see* Shoup Mission, Report on Japanese Taxation (1949), adopted an accessions tax but later replaced it with an inheritance tax.

B. Social, Moral, and Political Justifications

1. *Wealth Taxes in General*

The measure of tax capacity is not the only justification for levying taxes on net property ownership. Major concentrations of wealth held by a relatively small number of people can have many unfortunate political and social side effects; to the extent that these concentrations can be reduced through wealth taxation, the side effects can be ameliorated. First, the very wealthy may be able to influence government, either through legal or illegal means, in a manner far disproportionate to their numbers; such influence may result in government actions designed to protect the interests of the propertied elite.[21] In addition, it may be seen as an affront to democracy that a group of people can exercise disproportionate power. Second, some may consider it a moral affront that large divergences in wealth exist in a particular country. This latter justification for wealth taxation admittedly imposes a moral belief on a country that may or may not actually be present. Moreover, moral justifications for wealth taxation may also run counter to dominant social cultures, such as capitalism and wealth creation, that may prevail in the country.

In particular, the wide disparity of wealth found in many developing countries may exacerbate political or social problems. Legacies of colonialism and authoritarianism may include popular beliefs, whether justified or unjustified, that economic elites gained their position through illegitimate means. Such economic elites may tend to be grouped in definable religious, ethnic, or racial groups, exacerbating tensions among such groups. A special wealth tax on these groups may work to reduce such tensions.[22]

More conservative commentators have argued that the government should not seek to violate the rights of property in too ambitious a fashion

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[21]For example, former President of the United States Franklin Roosevelt, no pauper himself, remarked in his 1935 Address to Congress that "[g]reat accumulations of wealth . . . amount to the perpetuation of great and undesirable concentration of control in a relatively few individuals over the employment and welfare of many, many others." Franklin D. Roosevelt, Message to Congress (June 19, 1935), in H.R. Rep. No. 1681, 74th Cong., 1st Sess. (1935), *reprinted in* 1939-1 C.B. (pt. 2) 642, 642–43, *cited in* Mark L. Ascher, *Curtailing Inherited Wealth*, 89 Mich. L. Rev. 69, 95–96 (1990). John Rawls, one of the most influential contemporary liberal English-speaking legal philosophers, writing in favor of intergenerational wealth transfer taxes, argues that "concentrations of power [are] detrimental to the fair value of political liberty." John Rawls, A Theory of Justice 279 (1971).

[22]While the taxation of the wealthy will not provide sufficient revenue to significantly benefit the poor directly, afflicting the comfortable may benefit the poor psychologically. Revenues raised from a wealth tax can also be spent directly on programs to aid the poor. *See* Richard Bird, *Public Finance and Inequality*, 11 Finance and Development 2–4, 34 (1974). These may be among the reasons for South Africa's recent adoption of a temporary net wealth tax. *See* Patti Waldeman & Michael Holman, *South Africa Imposes Wealth Tax and Curbs Spending*, Financial Times, June 23, 1994, at 1.

in order to advance equality.[23] Also, economists have argued that both experience and analysis strongly suggest that wealth taxes, at least as they now exist, are unlikely to have much effect on actual wealth distribution. If so, why bother?[24] However, even if a tax on wealth did not have a substantial effect on wealth distribution, even a marginal effect may be preferable to none at all.

A perhaps more compelling argument is that the nonmonetary benefits of wealth create another type of tax capacity. For example, Professor Bird argues that wealth carries with it "a degree of security, independence, influence, and social power that is not adequately measured by the flow of realized money income to which it gives rise. . . . Wealth constitutes, at least to some extent, *an independent tax base* that is appropriately tapped by an annual tax on net wealth."[25]

2. *Wealth Transfer Taxes*

Commentators have advanced a number of additional arguments against the desirability of allowing unfettered intergenerational transfers of substantial wealth. Some have argued that, because heirs have done nothing to earn their wealth, there is greater moral justification for taxing gifts and estates or inheritances.[26] Taxing such wealth acquired through "family lottery" may therefore be perceived to be fairer than other types of taxation.[27] Other commentators have argued that taxing transferred wealth may help bring about greater equality of opportunity for the next generation. The argument favoring the advancement of equality of opportunity by creating a more "level playing field" for each new generation has both moral and economic aspects to it.[28] The economic aspect is discussed below.

Again, more conservative political philosophers have taken issue with the argument that the government should actively seek to level the playing field for new generations,[29] while economists have argued that wealth taxes do not raise enough revenue to level the playing field anyway. However, the economist Michael Boskin, who served as Chairman of U.S. President Ronald Reagan's Council of Economic Advisors, has responded that taxes on the

[23]*See generally* Friedrich A. Hayek, The Constitution of Liberty (1960).

[24]*See* OECD, *supra* note 9, ¶¶ 0.21–0.22; McCaffery, *supra* note 15, at 294.

[25]Bird, Tax Policy and Economic Development, *supra* note 12, at 133 (emphasis added).

[26]For example, the economist Cedric Sanford writes "[T]he particular ethical justification for taxing inherited property [is] that its acquisition is generally unrelated to the *merits* and efforts of those who benefit from it (emphasis added)." Cedric Sanford, Taxing Inheritance and Capital Gains: Towards a Comprehensive System of Capital Taxation 11 (1967).

[27]*See, e.g.*, Lawrence McQuaig, Behind Closed Doors 347 (1987).

[28]*See generally* Kurt Klappholz, *Equality of Opportunity, Fairness, and Efficiency, in* Essays in Honor of Lord Robbins (Maurice H. Peston & Bernard Corry eds., 1972).

[29]*See* Friedrich A. Hayek, *supra* note 23, at 87–91.

transfer of wealth can at least help prevent "*extreme* concentrations of wealth from being passed from generation to generation."[30]

C. Economic Efficiency

1. *Wealth Taxes in General*

Taxes on wealth are sometimes described as being more economically efficient than taxes on income. Some have argued that wealth taxes have a smaller effect than the income tax on the choice between work and leisure because they are not levied on productive activities, only on accumulated capital.[31] Others have argued, however, that because wealth taxes are not levied on consumption, they are likely to reduce rates of savings.[32] A counterargument is that, in order to maintain a desired rate of after-tax savings, wealth tax payers may increase their savings rate.[33] Wealth taxes may also encourage capital flight; theoretically, any tax on capital will induce mobile capital to migrate (and influence capital to stay out) until the overall rate of return on capital rises to offset the tax.[34]

Another aspect of economic efficiency concerns the overall revenue yield from a wealth tax relative to the economic costs of collecting it.[35] One argument is that, for wealth taxes to collect a substantial amount of revenue, they would have to be so onerous as to either create insurmountable political opposition or result in substantial negative economic effects. Therefore, some have suggested that wealth taxes probably need to be justified largely for social and political reasons, rather than simply for revenue reasons. However, if the cost of administering a wealth tax can be minimized, even relatively small amounts of revenue can be important to countries suffering from deficits.

2. *Wealth Transfer Taxes*

Wealth transfer taxes may have additional economic benefits. An individual who inherits property or receives it as a gift may have less incentive to

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[30]Michael J. Boskin, *An Economist's Perspective on Estate Taxation, in* Death, Taxes, and Family Property 56, 65 (Edward C. Halbach, Jr., ed. 1977), *quoted in* McCaffery, *supra* note 15, at 289 (emphasis added).

[31]*See, e.g.*, Goode, Government Finance in Developing Countries, *supra* note 14, at 134. *See also* Sanford, *supra* note 26, at 25 (1967); Joseph Pechman, Federal Tax Policy 234–35 (5th ed. 1987).

[32]*See* McCaffery, *supra* note 15, at 294–95; M. Zühtü Yücelik, *Taxation of Bequests, Inheritances, and Gifts, in* Tax Policy Handbook 188, 190–91 (Parthasarathi Shome ed., 1995).

[33]Yücelik, *supra* note 32.

[34]*See* OECD, *supra* note 9, ¶ 1.11.

[35]Gerald Jantscher, for example, argued that it may be far less costly administratively to raise the same amount of revenue by increasing other taxes, including the income tax. Gerald Jantscher, *The Aims of Death Taxation, in* Death, Taxes, and Family Property, *supra* note 30, at 142.

work to accumulate assets on her or his own. Taxing inherited wealth may increase the incentive for the heir to work or, at least, will not act as a disincentive against work.[36] In addition, one does not choose one's offspring on the basis of their ability to invest capital; persons who have accumulated capital through skill may as likely as not pass that capital on to fools. However, others have suggested that a principal reason for accumulating wealth is to pass it to one's heirs. As noted earlier, a tax on such wealth may result in either a decrease in work to accumulate wealth or an increase to maintain the same after-tax bequest.

Overall, both the theoretical and empirical research on such economic effects is far from conclusive. Professor Bird concludes that "[i]t is safe to say that there is as good (or bad) an economic case for, as there is against, wealth taxes."[37]

D. Problems of Administration

1. *Net Wealth Taxes*

Lord Kaldor recommended that developing countries impose periodic taxes based on the actual total cash and net property owned by an individual.[38] However, in the years since Kaldor made his proposals, taxes on net wealth have frequently been deemed too impractical, particularly in developing countries. Problems of uncovering the ownership of wealth and assigning it to particular taxpayers, and of accurately determining net values, can combine to make the tax especially difficult to enforce. On the basis of substantial experience, Richard Goode concludes that "[a] net wealth tax, although attractive in principle, must be judged impractical in most developing countries."[39]

Nevertheless, modern net wealth taxes, if designed with ease of administration in mind, can be effective, even in developing and transition countries. The features necessary to simplify administration include employing large exempt amounts and taxing legal persons and other entities in lieu of interests in those entities.

2. *Wealth Transfer Taxes*

Fiscal experts have often argued that wealth transfer taxes may be easier to administer than net wealth taxes and have therefore tended to be less skep-

[36]*See* John Wedgwood, The Economics of Inheritance 194–95 (1929).

[37]Bird, Tax Policy and Economic Development, *supra* note 12, at 136. Gerald Jantscher reached a similar conclusion. *See* Jantscher, *supra* note 35, at 46.

[38]*See* Kaldor, Suggestions for a Comprehensive Reform of Direct Taxation, *supra* note 13, at 14.

[39]Goode, *supra* note 14, at 135. One commentator notes that Finland's tax (at a rate of 0.9 percent on net wealth exceeding Fmk 1 million ($186,440)) "is a good tax in theory, but an unsatisfactory tax in practice." Kari Tikka, Tax Reform in the Nordic Countries 105 (1973–1993 Jubilee Publication of the Nordic Council for Tax Research, 1993).

tical about their adoption in developing and transition countries.[40] While the problem of making accurate net valuations is probably no easier under a transfer tax than under a net wealth tax, the problems of uncovering wealth and of assigning ownership to it are often smaller. The principal reason for this is that transfer taxes are generally assessed when the legal rights of ownership change, either through the giving of a gift or through death.[41] Such changes in ownership happen relatively infrequently and are likely to be easier for tax administrations to keep track of. Also, to protect her or his new ownership interest, the recipient has a clear interest in ensuring that the necessary legal requirements to reflect the appropriate ownership change are completed. The act of registering such ownership changes may be easier to uncover than ferreting out unchanging ownership interests. Also, property rules can be adopted that prevent the legal accession to wealth if a wealth transfer tax is not paid.[42]

Administrative costs as a percentage of revenue are likely to be lower for a transfer tax than for a net wealth tax, since the former is by and large collected only at death, while the latter must be collected every year.

However, in some ways, wealth transfer taxes are more difficult to administer than net wealth taxes.[43] Unlike yearly net wealth taxes, transfers through gift and at death are not predictable, and taxing them requires a number of adjustments (described later in this chapter), whether for political or technical reasons. Second, because legal persons do not die, it is more problematic than under the net wealth tax to tax them as a surrogate for taxing their owners.

The administration of both net wealth taxes and transfer taxes could be concentrated on a relatively few large holdings of wealth. If a principal goal of a wealth tax is to deal with very large concentrations of wealth, a large exemption amount could easily be justified. This may be particularly true in the context of many developing countries, where the very wealthy may be relatively easy to identify. A net wealth tax or wealth transfer tax with a large exempt amount may be administratively feasible in many jurisdictions.

E. Conclusion

Ultimately, the decision whether to enact a tax or taxes on net wealth or wealth transfer must take into account the country's political, social, and administrative circumstances. The principal policy goals behind a wealth tax might include (1) a modest reduction in current concentrations of substantially great wealth, (2) a modest reduction of the concentration of similar wealth in the future, (3) the social and political benefits to be achieved from

[40]*See* Yücelik, *supra* note 32, at 188.

[41]In the case of property held by trusts and trustlike entities, the transfer of property ownership may not be complete. The issues raised by this problem are discussed *infra* sec. III(I).

[42]A number of issues relating to the specific jurisdiction's laws of inter vivos and testamentary transfer affect the design of a wealth transfer tax. These issues are discussed *infra* sec. III(A), (I).

[43]*See infra* sec. III(A), (H).

realizing these goals, and (4) the general raising of tax revenues. In addition, several factors are important in choosing among the different systems of taxing wealth transfer. These include (1) overall fairness, (2) administrative convenience, and (3) political and popular support for enactment and enforcement.

Unlike taxes such as the VAT, excises, and income tax, which very few countries can do without, developing and transition countries can generally get along without taxes on wealth without serious consequences for either revenue or progressivity. Reforms of the income tax can often bring more revenue from the wealthy than is brought by wealth taxes. However, if, on the basis of the above factors, a decision is made to adopt a wealth tax—or to revitalize a moribund wealth tax that has been on the books without adequate enforcement—the timing should be decided upon so as not to distract from the collection of revenues from other taxes. The costs of administration should be seriously considered and the tax designed accordingly. Care should be taken to design the tax so that it will apply in an evenhanded manner, and adequate time should be allowed for drafting the law so that the tax can be effective.

II. Issues in the Design of Periodic Net Wealth Taxes

Periodic net wealth taxes and wealth transfer taxes share many design issues. However, the two forms of taxation are different enough to be considered sequentially below, starting with periodic net wealth taxes. Because of shared issues, the discussion of transfer taxes will frequently refer back to the previous discussion of net wealth taxes.

A. Taxpayers

1. *Physical Persons and Residence*

Typically, physical persons are taxed either as individuals or, with a spouse or any minor children, as part of a family group.[44] When net wealth taxes are applied on a flat-rate basis, aggregation of family wealth benefits the taxpayer, assuming that it involves applying exemptions on a per person basis, although no more than the taxpayer could have obtained through self-help by splitting wealth among the members of the family.[45] However, if the tax is applied at graduated rates, there will be a more significant difference between

[44]For example, in France under the net wealth tax, the taxpayer is either an individual or a family. A family is defined to include spouses and minor children, as well as any "concubine" and her minor children. FRA CGI art. 885E.

[45]For example, in Germany, families are taxed as groups, a single rate is applied, and an exemption of DM 70,000 is allowed for each spouse and minor child. Additional exemptions are provided for elderly and disabled persons. *See* DEU VStG § 6. Nonresidents are not entitled to the exemption. *See id.*

taxes applied at an individual level and those applied at the family level. Under graduated tax rates, the tax unit is often the family. This makes sense in that family wealth is often shared, either legally, as in community property regimes, or practically.[46] In a developing or transition country that adopts a net wealth tax with a large exempt amount, one would expect to have a family unit of taxation, but probably without a full exempt amount for each of the children.

The taxation of resident and nonresident physical persons is considered further in connection with the taxation of entities. Under a net wealth tax, in general, residents are typically taxed on their worldwide net assets, while nonresidents are frequently taxed only on their assets that are physically located within the jurisdiction.

2. *Entities and Resident and Nonresident Owners*

There are a number of other important connections between the taxpayer and the composition of the tax base. In most jurisdictions, only physical persons (individuals and families) are taxed.[47] This means that, if all wealth is to be included in the base, wealth that is held indirectly through legal persons or other entities must be attributed to the physical person taxpayer.[48] Moreover, attribution is necessary to prevent the double taxation of capital owned by entities. This involves determining who is the holder of the ownership interest and valuing the interest. In certain circumstances, both of these tasks can be relatively easy. For example, the ownership of the shares of a company can be revealed by examining the company's share register. And, if the company is listed, valuing the shares will also be relatively easy.

However, ownership interests in entities other than companies, partnerships, or other typical methods for organizing a joint business enterprise might be much more difficult to ascertain, and valuation of those interests, particu-

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[46]The rules concerning community property between spouses are diverse and depend on the legal tradition of the particular jurisdiction. The general rule, that all property acquired during marriage other than by gift, devise, or descent, is owned in half shares, is found in most civil law jurisdictions, as well as in some common law ones, although the traditional common law rule does not provide for community property. *See, e.g.*, Civil Code arts. 1401–408 (FRA); William de Funiak & Mark Vaughn, Principles of Community Property (2d ed. 1971). In Islamic law there is no standard community property rule, although, as part of a marriage contract, a man must present his wife with a dower. David Pearl, A Textbook on Muslim Personal Law 60–76 (2d ed. 1987). The rights of spouses and heirs to property following death are also often regulated by law and may be of particular importance to the operation of wealth transfer taxes.

[47]*E.g.*, FRA CGI art. 885. This is also the general rule followed in the Nordic countries. In fact, Germany's law is the exception. *See infra* note 66.

[48]For example, in France, wealth held by physical persons through companies, associations, and foundations is included in the physical person's tax base by valuing the ownership interest. FRA CGI arts. 885A, 885N, 885O.

larly if not publicly quoted, may also be difficult.[49] Moreover, debt interests in all types of legal persons, which are often held as bonds in bearer form, may be relatively easy to conceal from the taxation authorities.

In addition to typical for-profit business entities, where ownership interests are often relatively clear (if sometimes easy for the taxpayer to hide), persons may hold wealth more indirectly through equity-type interests in entities for which identification of the owner, as well as the nature of the interest, can be quite difficult. Perhaps the most important of these is pension funds. While pension funds may (depending on the jurisdiction) hold title to considerable amounts of wealth, the vesting rules for pension benefits may make determination of the value of a beneficiary's interest particularly difficult.[50]

The same type of problem is presented by family trusts, family foundations, and similar entities. These entities are often set up by individuals to hold and manage wealth.[51] The trust is a creation of the common law and is not found in either the French or the German civil code.[52] However, trust laws, although occasionally more limited in scope than under common law, have been adopted in a number of Latin American countries[53] as well as in a few other jurisdictions.[54] The basic legal concept of the trust is the separation of the ownership interests in property into a legal title, held by one or more trustees, and an equitable title, held by one or more beneficiaries. The legal title gives the trustees control over the property, while the equitable title gives the beneficiaries rights to the benefit of the property.[55] Benefits may favor some beneficiaries over others and may

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[49]The general matter of valuation is considered *infra* at secs. II(B)(3) & III(F). *See also infra* text accompanying notes 51–67 concerning legal forms of organizing business enterprises.

[50]*See* Joseph Pechman, Comprehensive Income Taxation 77–84 (1977). The issues with regard to identification of beneficiary are similar for both income and wealth taxation. Pension funds are often created in the legal form of a trust, foundation, or similar entity. A discussion of these forms of legal organization follows immediately *infra*.

[51]These entities can also be used for regular, for-profit business purposes. However, in these cases it is typically not difficult to ascertain who the investors are and to attribute wealth directly to those investors. *See* Richard K. Gordon & Victoria P. Summers, *Trusts and Taxes in Civil Law Emerging Economies: Issues, Problems, and Proposed Solutions*, 5 Tax Notes Int'l 137, 142–43 (1992).

[52]*See generally* the historical discussion in George G. Bogert, Law of Trusts and Trustees, Section 3 (2d rev. ed. 1984).

[53]Bolivia, Costa Rica, El Salvador, Guatemala, Mexico, Panama, Puerto Rico, and Venezuela have each adopted some kind of civil code provision for trusts, although they vary greatly in extent. *See* William F. Fratcher, *Trust*, *in* VI International Encyclopedia of Comparative Law 11-104 (1973). Moreover, there is a convention on the recognition of trusts, *see infra* note 65.

[54]Quebec has long had trust provisions. *See* Civil Code, arts. 1300–37 (Quebec). In 1989 Mauritius adopted complete trust provisions. Mauritius Public Trustee Act of 1989 (Act 27 of 1989); Mauritius Trusts Companies Act of 1989 (Act 28 of 1989). In 1992 the French Government introduced comprehensive trust legislation. *See* Jean Delattre, *France Introduces Comprehensive Regime for Trusts*, 4 Tax Notes Int'l 643–44 (1992). However, the bill was withdrawn before enactment.

[55]*See, e.g.*, Restatement (Second) of Trusts § 2 (1959); 1 Austin W. Scott & William F. Fratcher, The Law of Trusts §§ 2.3–2.6, at 40–48 (4th ed. 1987–89).

change over time. It is often true that no particular beneficiaries or beneficiary has the full right to enjoy all the benefits of the property, nor are the shares of the respective beneficiaries fixed. This can make determining the attributes of ownership of the underlying wealth exceptionally difficult.[56]

Civil code countries that do not have trust provisions frequently have other rules that permit the creation of entities involving trustlike relationships. These include the family or private foundation. Such entities, known as *fondation* in French and *Stiftung* in German, are similar to trusts in that legal title to property is held by one person, while the benefits of the property accrue to others. In France and other jurisdictions that follow the French model, *fondations* may be set up with approval from the appropriate governmental agency.[57] The German civil code provides for foundations both with and without independent legal existence.[58] Foundations are managed under the terms of a notarial deed of mandate or a "constitution." Neither specific beneficiaries nor beneficiary rights need be noted in the constitution.[59] Therefore, the foundation can duplicate many of the problems found with family trusts in attributing ownership rights.

Other forms of ownership of property under different legal regimes can create similar wealth attribution problems. Islamic law recognizes the *waqf dhurri*, which can be translated as "family foundation."[60] There is disagreement among the different schools of Islamic law as to who actually owns the property held in the *waqf*; in Shi'i law the ownership of the underlying property itself is also vested in the beneficiaries, while in Hanafi law it is the property of God, raising interesting issues of ownership attribution.[61] Regardless, as with the trust and family foundation, it can be difficult to attribute ownership to particular taxpayers. In addition to civil code and Islamic law foundations, customary law entities may exist that could frustrate the operation of a net wealth tax levied on physical persons only, for example, the *yayasan* in Indonesia,[62] or

[56]*See generally* Gordon & Summers, *supra* note 51, at 137.

[57]There are no provisions in the French Civil Code concerning the creation of foundations; instead, they are a construct of French common law. *See generally* Maurice Pomey, Traité des fondations d'utilité publique (1980).

[58]Civil Code arts. 80–88 (DEU).

[59]*Id.*

[60]All *waqfs* must have a purpose that pleases God. This admonition has occasionally led to mistranslation of *waqf* as a charitable foundation. However, support of family and friends, if not otherwise in violation of law, is considered pleasing to God. Akshoy Rekhi, The Law of the *Waqf Dhuree* (1993). *See also* The Qur'an, Surah II 177 (M.H. Shakir trans., 7th ed. 1994) (quoted at the beginning of this chapter). *See generally* Monica M. Gaudiosi, *The Influence of the Islamic Law of Waqf on the Development of the Trust in England: The Case of Merton College*, 136 U. Pa. L. Rev. 1231 (1988).

[61]*See* Pearl, *supra* note 46, at 197.

[62]The *yayasan* is a creature of both customary law and of the civil code, and is similar in most respects to the *fondation* and the *Stiftung*. *See* Civil Code arts. 365, 899 (IDN); Soetjipto Wirosardjono, From Foundation to Foundation (Aug. 12, 1991) (unpublished manuscript on file with the authors) (discussing how the civil code provisions concerning the *yayasan* make only reference to them, while the operation of the *yayasan* is governed by customary law).

real property rights vested in an entire community found in many developing countries.[63]

Foreign laws can be relevant to the structure of the ownership interests of residents. For example, a resident of a French civil code country (or indeed a resident of many counties with other laws) can set up a Cayman Islands trust or a Liechtenstein *Stiftung*.[64] In addition to the considerable administrative problems that could arise, the legal question of ownership of the corpus of a trust or family foundation would still be important to the country of residence.[65]

Some jurisdictions tax not only physical persons on their property, but also certain entities.[66] The entity can be taxed as a surrogate for the person or persons who receive the benefits of ownership. Such an approach can help obviate the need for identifying and attributing the many different forms of ownership interests that can be created in entities; however, as noted below, if the entity is taxed, provision must be made to prevent double taxation if the owner of the entity is also subject to tax. Moreover, similar to the case of taxing a family as a unit, a problem with taxing entities as a surrogate for taxing their owners or beneficiaries arises if the wealth tax is levied at graduated rates (or involves exempt amounts).[67] Incentives would exist to split assets into a larger number of entities so as to take advantage of lower marginal rates. The alternative of taxing entities at the top marginal rate would result in some persons being overtaxed.

Another consideration is that if both physical persons and entities are taxed, double taxation can occur unless ownership interests in taxable legal persons are themselves exempt. This is the case in Germany, where the value of an ownership interest in an entity is generally included in the tax base of

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[63]For example, among at least some of the Bataks of north Sumatra, real property is not only held by living members of the ethnic group, but by generations yet unborn. Complete agreement by all members of the group must be secured before alienation of real property may take place, and the rights of future generations must also be considered. Norman Pakpahan, Notes on Group Ownership under Batak Customary Law (Sept. 16, 1992) (unpublished manuscript on file with the authors).

[64]Commercial Code arts. 552, 558 (LIE). We are informed that this jurisdiction has become a center for *Familienstiftungen* created by foreigners. We are further informed that, in particular, many wealthy Central Americans wishing to avoid wealth (among other) taxes have set up such *Stiftungen* there.

[65]*See generally* Convention on the Law Applicable to Trusts and on Their Recognition (1984).

[66]In Germany, the taxpayers are basically the same as those who are subject to corporate income tax. *See* Klaus Tipke & Joachim Lang, Steuerrecht 469 (1991). Taxpayers include "associations, foundations, and other funds of private law that do not have legal personality." *See* DEU VStG §§ 1, 2. This means that partnerships are generally not subject to net wealth tax. (For discussion of application of corporate tax in Germany to partnerships, *see* vol. 2, chs. 19, 21.)

[67]*See supra* note 8. The German net wealth tax has a flat rate for entities, but includes an exemption for the first DM 500,000 of business assets; taxpayers with net wealth below DM 20,000 are also excluded from the tax. The latter of course also involves a "cliff" problem, with a high marginal rate (although not necessarily a large amount of tax) on taxpayers whose wealth increases to just above the threshold. For German wealth tax rates on individuals, *see supra* note 45.

residents, but where the net wealth of entities is also, with limited exceptions, separately taxed and at a higher rate.[68]

A related problem exists with regard to nonresidents who have ownership interests in resident entities that themselves own property not located in the jurisdiction. As noted above and discussed below at greater length,[69] residents are typically taxed on their worldwide net assets, while nonresidents are frequently taxed only on their assets that are physically located within the jurisdiction. However, if legal persons and other entities are taxed on all their net wealth, including wealth located abroad, then nonresidents with interests in a resident legal person will also be taxed on those assets located abroad. The result is that they will be overtaxed, compared with a situation in which they owned their share of the legal person's assets directly. The statute can be drafted to correct this distortion in the manner suggested below.

The technique of taxing entities as a surrogate for taxing their owners will not work for nonresident entities because they may be beyond the effective administrative reach of the jurisdiction. Therefore, interests in nonresident entities would have to be included in the net wealth tax base of the resident physical persons who own them. In such cases, many of the daunting issues discussed above with regard to trusts and similar entities resurface.

Finally, the question arises as to whether debt interests, such as bonds, should be separately attributed and valued or should be included in the surrogate tax levied on legal persons. As noted at the beginning of this chapter, the tax base of the net wealth tax is the sum of assets minus liabilities. However, it would be possible to levy a surrogate tax on the value of a bondholder's investment in a legal person by not allowing liabilities as a deduction from a legal person's tax base. In such cases, all wealth in the form of bonds and other debt interests in resident legal persons should be excluded from the tax base to avoid double taxation. The authors are not aware of any net wealth tax that adopts this approach, but some countries with an assets tax that acts as a minimum income tax do take such an approach to debt instruments.[70]

3. *Exemptions*

The agencies and instrumentalities of government are normally exempt from net wealth taxation; such entities are already publicly held, and levying a wealth tax on them would not advance any of the stated goals of wealth taxa-

[68] *See* DEU VStG §§ 1, 10(1)(2); Tipke & Lang, *supra* note 66, at 469. However, if a taxpayer owns shares that constitute more than 10 percent of the registered capital of a resident company, those shares are exempt from the tax base under the so-called affiliation privilege. *See* International Bureau of Fiscal Documentation, The Taxation of Companies in Europe: Germany ¶ 392 (1991).

[69] *See infra* sec. II(B)(1).

[70] *See infra* ch. 12, sec. III(C). *See also* vol. 2, ch. 19, which discusses the analogous issue under the income tax.

tion.[71] Also, not-for-profit entities may, depending on the particular jurisdiction, enjoy an exemption from net wealth tax. For example, in Germany the exemption applies to not-for-profit entities that provide education, health services, or social assistance or that support religious activities.[72] A number of arguments favor such exemptions. One is that if the beneficiaries of not-for-profit legal persons constitute either the public at large or a reasonably broad segment of that public, they should receive an exemption for the same reason that agencies and instrumentalities of the state do. In other words, it makes little sense to redistribute wealth from an entity that benefits the general public.

Another argument is that charitable activities should be encouraged, and an exemption from wealth taxation may serve as a reasonable tax subsidy.[73] However, exemptions may spread far beyond such limited parameters. For example, Germany exempts such diverse entities as pension funds, small mutual insurance companies, public utilities, and certain capital participation companies.[74] The pension fund issue is, of course, quite controversial. On the one hand, exempting pension funds seems counter to nearly all the arguments advanced for taxing wealth in the first place. Such funds can hold considerable wealth, and beneficiaries are typically physical persons.[75] On the other hand, the bulk of the pension fund's rights may be allocated to savers whose taxable net wealth does not exceed the threshold for wealth tax. With respect to charities, a blanket exemption for charitable institutions could be taken advantage of by family foundations that, even if restricted to charitable purposes, can involve family control over wealth, presumably a target of a wealth tax. Excluding charitable private foundations from an exemption for charities would involve some drafting and administrative complexity, in that it would require defining private foundations, not an easy task. Alternatively, all charities could be taxed, but only on their business or investment assets, that is, not on assets used in charitable activity.

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[71]*See, e.g.* DEU VStG §§ 3(1)(1), 3(1)(1a), 3(1)(2), 3(1)(2a). These do not include legal persons owned by the state but that do not act in a governmental or sovereign function.

[72]*See, e.g.* DEU VStG §§ 3(1)(4), 3(1)(12).

[73]This argument can be made to advance exemption for all forms of taxation of socially beneficial not-for-profit enterprises. *See* Yishai Beer, *Taxation of Non-Profit Organizations: Towards Efficient Tax Rules*, 2 British Tax Rev. 156 (1995). Other arguments also exist, including that an exemption from taxation for all not-for-profit enterprises (meaning those that cannot distribute earnings to owners) can help compensate for difficulties not-for-profit entities experience in raising capital. *See* Henry Hansmann, *The Rationale for Exempting Non-Profit Organizations from Corporate Income Taxation*, 91 Yale L. J. 54 (1981) (although the arguments advanced are addressed to income taxation, they largely also apply to wealth taxation).

[74]Some of the exemptions are linked to exemption from corporate income tax. *See* DEU VStG § 3.

[75]Some may argue in favor of exempting pension funds from wealth tax as an incentive for individuals to save. However, as with any government investment subsidy, this can create misallocations of investment and tax administration problems as individuals structure their investments for rent-seeking purposes. *See* Richard K. Gordon, *Privatization and Legal Development*, 13 B.U. Int'l L. J. 367, 374–75 (1995).

4. *Implications for Drafting*

If a developing or transition country wishes to adopt a net wealth tax, relative ease of administration suggests that, in addition to physical persons, at least those legal persons and other entities whose ownership interests cannot be readily attributed to identifiable persons should also be subject to tax. To avoid double taxation of wealth held by entities (and to obviate the need to attribute and value ownership interests), interests in those taxable entities should themselves be exempt from tax. Under a progressive rate schedule, the rate for such persons should probably be the top rate for physical persons. Although this will result in overtaxation of interests held by physical persons who are taxed at lower rates or who do not pay wealth tax, the consequences of this effect are likely to be minor. In this case, the trade-off between fairness and administration probably militates in favor of administration.

A developing or transition country would probably be advised to adopt a large exemption amount and a single, low rate of tax (something like the German rate of 0.5–0.6 percent; in any event, probably not more than 1 percent). The flat rate would simplify the operation of the tax, as it would provide equal treatment for wealth held inside or outside an entity.

To avoid an incentive to set up numerous legal persons, legal persons could be denied an exempt amount. However, a *de minimis* exemption may have considerable administrative advantages. If the *de minimis* amount is small enough, and if attribution rules are adopted that allow the taxation authority to group together legal persons whose beneficiaries are the same, there may not be too much incentive for taxpayers to take advantage of the exemption by setting up numerous legal persons. The *de minimis* amount should probably be in the form of an exemption rather than a threshold that determines taxability of the legal person; this will avoid the peculiar result in Germany where marginal tax rates over a small range can be astronomical.[76]

Overtaxing nonresidents who have ownership interests in legal persons that themselves hold wealth not located in the jurisdiction might create a disincentive for nonresident investment. It might make sense in such cases to exclude as taxpayers those legal persons most likely to have both reasonably significant numbers of nonresident investors and substantial amounts of foreign assets. Another, more accurate solution would be to give such legal persons the option of paying either a full wealth tax or two separately calculated surrogate taxes, one for residents and one for nonresidents.[77]

[76] *See supra* note 67.

[77] The first tax could be the sum of the company's net assets, multiplied by a fraction equal to the ratio of the total value of shares held by resident shareholders to total value of all shares. The second could be the sum of the company's net assets located in the jurisdiction, multiplied by a fraction equal to the ratio of the total value of shares held by nonresident shareholders to total value of all shares. Determining which of these solutions should be chosen will depend on the size and nature of the transnational investments and on the capabilities of the tax administration.

It might be preferable if legal persons and other entities that are taxed as a surrogate for taxing their investors were taxed on their gross, rather than on their net, assets. This would mean that those who had both equity and debt ownership interests in the entity would be covered by the tax. Therefore, both equity and debt interests in legal persons and other entities subject to wealth tax would be exempt from the tax base.[78]

B. Tax Base

1. *Base for Residents and Nonresidents*

As mentioned previously, it is common for wealth taxes to distinguish between residents and nonresidents, with the former being taxed on their worldwide net assets, and the latter only on those assets located within the jurisdiction.[79] Presumably, the reason for taxing a resident's entire net wealth is that the sum of such wealth, wherever it is located, determines the person's tax capacity. The justification for taxing nonresidents on their assets located within the jurisdiction is less clear. There is the obvious practical consideration that these are the only assets that the jurisdiction is likely to be able to tax. Also, if one of the justifications for the wealth tax is to reduce the inequality of asset ownership within a jurisdiction, to leave out all assets within it that are owned by nonresidents would make another policy justification of wealth taxation—a modest reduction in inequality of wealth—harder to implement.

Taxing assets within the jurisdiction can also form part of international coordination of the net wealth tax. If most jurisdictions taxed domestic assets (together with worldwide assets of residents) and allowed relief for foreign wealth tax paid on assets located abroad, there would be no double taxation, and each jurisdiction would tax the assets over which it is likely to have the greatest control. Given the relatively narrow degree of adoption of wealth taxes, this possibility is more of theoretical interest, although it could be relevant to a region in which all or most countries implemented a net wealth tax.[80]

To limit a nonresident's tax base to those assets located within the jurisdiction, it is necessary to define both residency and asset location. The criteria for determining residence are normally identical, or nearly identical, to those for the income tax.[81] Given that the net wealth tax is an annual tax like the income tax (or is levied for a few years at most), it makes sense to

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[78]If the approaches discussed in the paragraphs above concerning the taxation of nonresidents on nonresident assets in the case of certain companies were adopted, these could be appropriately drafted to take account of debt.

[79]*See, e.g.* FRA CGI arts. 885 1°, 885 2°; DEU VStG §§ 1, 2.

[80]At the moment, the greatest regional concentration of net wealth taxes seems to be in the EU, but even there it is far from universal.

[81]*See, e.g.*, FRA CGI art. 4B; 2 *Précis de fiscalité* ¶ 4825 (1994); DEU VStG §§1, 2. For a general discussion of principles of residence under the income tax, *see* vol. 2, ch. 18.

use the same rules as under the income tax for administrative simplicity. These rules focus on the taxpayer's status in the current year. As discussed below, longer-term rules may be appropriate for transfer taxes. However, given the tax advantage of ceasing to be a resident of a jurisdiction with a wealth tax, some taxpayers with considerable wealth located outside the jurisdiction may seek to expatriate to avoid tax. Such an attempt to avoid wealth tax could be countered through a rule that continues to impose a tax on all assets for a certain period after the residency status changes.[82] Another possibility would be to continue to impose tax on all assets if tax avoidance was a primary motivation for the person's change in residency.[83] Both measures suffer from the limitation that it is generally difficult for a country to enforce its tax laws in the territory of another sovereign country. An alternative would be to impose a tax at a much higher rate in the year of expatriation.

It is generally easy to determine whether tangible property is located within the country. Intangible property, however, raises more difficult issues with respect to its location. The location of many assets for purposes of determining the nonresident's tax base can be determined by analogy to general income tax principles.[84]

2. *Exemptions*

Certain assets are often exempted from the tax base for particular taxpayers. Statutes frequently provide a zero-bracket amount to exclude taxpayers who do not have sufficient wealth to warrant taxation.[85] Different jurisdictions have enacted various exceptions for different reasons. For example, in France, goods necessary for the practice of a profession are exempt, presumably so as not to burden the means necessary to an individual for the production of her or his livelihood.[86] However, given the relatively low rate of tax (between 0.5 and 1.5 percent of net worth)[87] and the large zero-bracket amount of nearly F 4.5 million,[88] such an exemption hardly seems necessary. France also seems to exempt other assets, such as woods and forests, for either ecological or po-

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[82]The United States has considered recent analogous legislation. *See* Expatriation Tax Act of 1995, H.R. 1812, 105th Cong. 1st Sess. (1995); Joint Comm. Tax'n, Explanation of H.R. 1812, JCX-26-95 (1995).

[83]*See* USA IRC § 2107 (renouncing of citizenship to avoid tax). The United States does not impose a wealth tax; in addition, the United States bases its tax jurisdiction on citizenship as well as on residency.

[84]*See* vol. 2, ch. 18. With regard to the debt of a legal person, see *infra* text accompanying note 105.

[85]For example, in France the zero bracket amount for 1994 was F 4,470,000, or $881,656 (French franc-U.S. dollar rate of Feb. 12, 1996). 2 *Précis de fiscalité* ¶ 4825 (1994).

[86]FRA CGI arts. 885N–R.

[87]*Id.* art. 885U.

[88]*See supra* note 85.

litical reasons.[89] At first blush, the French exemption for antiques, art objects, and collector's items[90] seems quite perverse in light of the earlier-enumerated goals of wealth taxation. The exemption may be related to the difficulty of administering such a tax on objects that are typically kept in the home of the taxpayer, as well as to concerns for preserving national culture and patrimony.

The French exemption for the value of rights to literary or artistic property, and the right of inventors to their inventions,[91] appears to be based on some other principle, perhaps to encourage innovation. The exemption for the capitalized value of certain life annuities payable as a pension or received as compensation for personal injury[92] appears designed to support other goals. France also exempts financial investments the income from which is sourced within the country, unless the investment is in a company or legal entity whose assets are principally immovable property or rights to such property.[93] This exemption seems designed to encourage foreign investment without acting as an incentive to foreign ownership of French real estate.

Perhaps one of the most important lessons to be drawn from these few examples is that exemptions should be as limited as possible, with carefully articulated criteria. Among those criteria might be that the exemption should either demonstrably advance the ease of administration of the tax or promote as efficiently as possible an articulated national policy, without undermining the objectives or purpose of the tax.

3. *Valuation*

Valuing net wealth often poses serious practical difficulties. Some jurisdictions, such as Germany, have a general valuation law that is used for all taxes.[94] Other jurisdictions, such as France, have different rules for income taxes and for wealth taxes.[95] The value of immovable property, for example, can be estimated using the same rules as for real property taxes or stamp taxes. This can of course lead to large inequities if the value for purposes of the other tax is distorted, but developing and transition countries in particular may have no realistic choice given administrative constraints. Because of the difficulty

[89]FRA CGI 885H.

[90]*Id.* art. 885I. The practice of exempting these assets is also followed in many other countries. *E.g.*, in Sweden, antiques, art objects, and collector's items are exempt from net wealth tax (*see* SWE SF, § 3(2)(e)), and jewelry in practice is hardly ever taxed.

[91]*Id.*

[92]FRA CGI arts. 885J, 885K.

[93]*Id.* art. 885L. *cf.* Germany, where nonresident individuals and entities are taxed on the net wealth located in the national territory. *See* DEU VStG § 4. However, the tax authorities in accordance with the Federal Finance Minister may decide on a full or partial exemption or establish a lump-sum assessment if it is justified for national economic reasons or if it is particularly difficult to evaluate the net wealth tax for nonresidents. *Id.* § 13.

[94]*See* DEU VStG § 4 (referencing DEU BewG).

[95]*See* FRA CGI art. 885S.

of performing a valuation, it is often provided that for certain kinds of assets a valuation remains in effect for a specific number of years, or there may be a formulary adjustment of the valuation for a specified period.[96]

For both net wealth taxes and wealth transfer taxes, certain types of interests can pose valuation problems and require special rules. Specific classes of property[97] and particular assets, for example, jewelry and collectibles, fall into this category.[98] Ongoing businesses that are not taxable as entities also pose difficulties.[99] One extreme approach to the problem of valuation could be to require the estate or owner to sell the property to the government for the amount claimed on the return (plus a specified premium) should the government wish to buy it.[100]

Ownership rights included in the tax base should be defined broadly. This broad definition should include direct undivided ownership interests, joint tenancy with rights of survivorship, ownership of property subject to dower, curtesy, or usufruct interests, and property transferred to the taxpayer where the transferor retains power over the property such as through a general power of appointment, a reversionary interest, or a retained life estate. While valuation of such split interests in property may be difficult, a general market value approach should usually be followed.

Perhaps the most difficult valuation problems are likely to arise from the varying forms of interests found in companies, partnerships, trusts, and other entities. As discussed above, the problem of valuing these interests may largely be taken care of through the taxation of entities as surrogates. However, in the case of nonresident entities, such indirect taxation is not usually possible. In these cases, it will be necessary to value the interest. With regard to companies and partnerships, estimates will have to be made of share and partnership values. Attribution rules found in income tax laws can help determine ownership interests.[101]

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[96]*See* OECD, *supra* note 9, at 62.

[97]For example, in Spain, time-share ownership is valued according to the percentage of ownership in property valued under the regular valuation rules or, if the taxpayer does not share in the ownership of the property, the value is the acquisition price for the time-sharing certificate or other instruments representing them. *See* ESP IP art. 10.

[98]*See, e.g.*, FRA CGI art. 764(II) (under the wealth transfer tax, art objects, precious stones, jewelry, or other collector's items may not be valued at less than their insured value at the date of death unless there is evidence to the contrary).

[99]For example, there are a number of difficulties with valuing small businesses. While a general method is to capitalize the earnings, that valuation method produces great difficulties when valuing personal service businesses. Merely taking the book value of assets as the value of the business substantially understates the value of assets not shown on the balance sheet, such as goodwill. For other issues in business valuation under the wealth transfer tax, *see infra* sec. III(F).

[100]This approach was used in a property tax statute in Zimbabwe. *See also* Luis F. Ramirez Acuña, *Privatization of Tax Administration*, *in* Improving Tax Administration in Developing Countries 377, 386 (Richard M. Bird & Milka Casanegra de Jantscher eds., 1992).

[101]*See infra* vol. 2, ch. 21.

In the case of publicly traded interests, market value can be defined as the mean between high and low market quotes on the valuation date.[102] With regard to valuing untraded interests, the law could provide a percentage increase for all controlling interests (with appropriate related-party rules), a percentage decrease for all minority interests in other than publicly traded companies, and a percentage decrease for large blocks of shares in publicly traded companies. This would eliminate much of the administrative difficulty and valuation problems in determining the appropriate premium for a controlling interest, minority discount, or blockage discount.[103] Alternatively, because valuation issues are difficult to deal with in a tax administration structure that lacks great sophistication, the statute could flatly disallow blockage or minority discounts.

The taxation authority may have difficulty determining the ownership of interests in family trusts, foundations, and similar entities. A number of countries have elaborate rules for determining who owns the beneficial interest in such entities.[104] Although such rules can be used to assign ownership interests in the wealth held by the entity, they can be difficult to implement. Developing and transition countries in particular may not wish to complicate their wealth tax administration by implementing such elaborate rules. Instead, they may prefer to adopt rules of thumb that assign ownership interests to the creator of the entity, or to the heirs and assigns, absent a showing by the beneficiaries as to what their respective beneficial interests are worth.

Of course, wealth taxes are due on net wealth, meaning values accounting for liabilities. As noted earlier, it may be considerably easier to tax debt interests in resident legal persons by using the legal person as a surrogate.[105] However, when valuing debts owed by nonresident legal or physical persons, it may be preferable to account for them directly. In the latter case, the physical person would deduct the value of the debt and the creditor would include the debt. This is because most creditors of physical persons are likely to be banks or credit finance agencies who can easily produce the necessary records concerning their lending activities.

C. Double Taxation

Net wealth taxpayers whose worldwide net wealth is subject to tax may be subject to double taxation. Double taxation can be eliminated either by

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[102]Another approach is to value listed securities in accordance with the last day's quotation or with the average of the last 30 days, as is done under the French wealth tax. *See* FRA CGI 885T *bis* (1988).

[103]A blockage discount reflects the lower value for company shares if they were liquidated in the market in one transaction rather than in a series of transactions because of the effect that the liquidation would have on the market price.

[104]*See, e.g.* USA IRC §§ 641–79. *See also* vol. 2, ch. 21.

[105]*See supra* secs. II(A)(4), (B)(1).

unilateral relief[106] or by tax treaties. For example, under treaties, immovable property is normally taxable in the country in which the property is situated. An important difficulty in relying on treaties is that there are relatively few that cover net wealth taxes. It is probably not a top priority for developing and transition countries to devote resources to negotiating treaties in this area. It therefore makes more practical sense for them to structure their net wealth taxes so as to impose the net wealth tax on nonresidents in a manner that is reditable in a nonresident's home country if that country levies a net wealth tax on worldwide assets.

Relief from double taxation for residents who are taxed on net wealth outside the country can be provided through a credit or an exemption. The issues are similar to those under the income tax.[107] Exemption is effective in eliminating double taxation and is relatively easy to administer because the only issue is the location of the property. Its disadvantage is that it may result in no taxation at all on assets located in jurisdictions without a net wealth tax. A tax credit approach ensures that a tax will be payable either to the foreign country or to the country of residence.

To implement a credit for foreign taxes, it is necessary to define a qualifying foreign tax. For example, what if the foreign country has a tax on the ownership of immovable property? Is this a net wealth tax that qualifies for the credit, or is it a property tax that does not? What if the income tax in the foreign country is creditable against the net wealth tax? Should a credit be allowed in that case only for the whole tax, only for the excess, or not at all? Should a credit be allowed at all for a tax that is in the nature of a minimum income tax? In addition to determining whether a foreign tax qualifies as a creditable net wealth tax, it is necessary to provide a mechanism for calculating the limitation on the credit.[108] This can be done on a per-country or an overall basis, as with the foreign tax credit under the income tax.

D. Administration

A time for filing returns and making installment payments must be provided. In most countries, net wealth is revalued annually, but in Germany and countries that follow the German model, it is generally done every three years.[109] It may be convenient to provide for net wealth tax returns to be filed at the same time as income tax returns. The returns should be cross-checked with income tax returns, so as to obtain information that may be relevant in

[106] *See* J.F. Avery Jones, A *Comparative Study of Inheritance and Gift Taxes: Introduction*, 34 European Taxation 335–36 (1994).

[107] *See* vol. 2, ch. 18.

[108] *See* ESP IP art. 32; DEU VStG § 11. In Germany the credit limitation is calculated on a per-country basis. As an alternative to the foreign tax credit, Germany provides for a 50 percent reduction in tax for certain business assets located abroad. DEU VStG § 12.

[109] *See* OECD, *supra* note 9, at 62–63; DEU VStG §§ 15–18.

auditing both taxes. Indirect controls for determining wealth tax compliance can be provided by requiring proof that the wealth tax has been paid for such transactions as the issuance of passports, sales and transfers of immovable property, and transfers of vehicles.

A distinction should be drawn in the law between the time that net wealth is measured (usually at a specific date every year) and the due dates for paying the tax. These may be set more frequently than once a year, particularly for taxpayers with larger amounts due.[110]

III. Design of Wealth Transfer Taxes

As noted earlier, an argument favoring wealth transfer taxes is that it may be easier to keep track of relatively infrequent changes in wealth ownership than it is to keep track each year of all the taxpayer's assets. However, this administrative advantage over net wealth taxes also carries with it an important difficulty. The principal policy goal of transfer taxes is to collect a certain percentage of intergenerational transfers of wealth. Unfortunately, people do not transfer wealth, whether by gift or at death, in a predictable manner. Transfers to members of the same generation or untimely deaths in successive generations may lead to excessive taxation under a transfer tax. More likely, insufficient tax may be collected as taxpayers plan to avoid the transfer tax by transferring wealth directly across more than one generation (a so-called generation-skipping transfer). Special provisions must therefore be made to account for these potential problems.

A. Taxable Transfer and Taxpayer

It is the transfer of wealth that attracts tax, but the tax rate is based on the total amount of wealth transferred. For this reason, the issues of who the taxpayer is and when a taxable transfer occurs are unavoidably and inextricably linked. Perhaps the most common transfer of wealth is from one spouse to the other, both by gift and at death. However, such a transfer would not typically be intergenerational. In addition, as noted earlier, some legal traditions consider the property of spouses acquired during their marriage as being common property.[111] This tradition may also be reflected in a spouse being guaranteed a certain share of the other spouse's property after death.[112] For these

[110] *E.g.*, DEU VStG §§ 20, 21.

[111] *See supra* note 46 and accompanying text.

[112] Such shares are quite common in civil law countries. *See, e.g.*, Civil Code art. 540 (ITA). In other civil law jurisdictions, the right to a spousal bequest depends on the needs of the surviving spouse. *See, e.g.*, Civil Code art. 1368 (MEX) (the testator must provide support for the surviving spouse if he or she is unable to engage in gainful employment and has insufficient means, with the right, except as otherwise expressly provided by the will, continuing as long as the surviving spouse does not remarry and lives an honorable life).

reasons, although most particularly the intergenerational one, many jurisdictions exempt transfers from one spouse to the other.[113] Other reasons include providing a uniform treatment of ownership between spouses, extending support to the spouse posthumously, and perhaps pure sentimentality. Some jurisdictions limit the rollover amount to only one transfer between spouses, so as to avoid the skipping of generations that results from having widows and widowers marrying younger spouses.[114]

The exemption of property transferred to a spouse will often depend on the citizenship or domicile of the transferee spouse. As with net wealth taxation, wealth transfer taxes typically restrict the tax base of nonresidents to assets located within the jurisdiction.[115] As noted earlier, a tax can be levied either on the transferor or on the transferee; the choice of which type of tax to adopt will depend, at least in part, on the type of legal rules affecting the transfers of property.[116] Under a transferee type of tax, a nonresident spouse would not, unless special rules exist, have to pay tax on assets located abroad. Under a transferor type of tax, the foreign assets would still be taxed, but all future transfers of those assets would be exempt. In the United States, which taxes the transferor, the spousal exemption does not generally apply to noncitizen transferees, but the transfer of property into a qualified trust for the benefit of the spouse is exempt under certain circumstances, a tax being due on amounts remaining in the trust at the death of the surviving spouse.[117]

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[113]*Compare* USA IRC § 2056(a)(unlimited marital deduction); GBR IHT § 18 (same); PNG WPA § 145 (same); *with* JPN IHT art. 19-2 (reduction of inheritance tax amount for spouse). In many countries, the allowance is not as generous. *See, e.g.*, DEN INH § 2(A) (no inheritance tax if the amount received by the surviving spouse does not exceed Dkr 100,000); FRA CGI art. 779 (F 330,000 personal allowance for transfers between spouses); Inheritance and Gift Tax Law § 12 (FIN) (the surviving spouse is allowed a deduction of Fmk 37,500 from the taxable inheritance); DEU ErbStG §§ 16, 17 (spouses are allowed a personal allowance of DM 250,000 for transfers of property by reason of death or gift and surviving spouses (an additional DM 250,000) and children up to age 26 (up to DM 50,000 depending on age) are granted a special maintenance allowance on transfers by reason of death).

[114]Other tax laws deal with this problem differently. *See, e.g.*, Luxembourg Loi concernant l'impôt sur la fortune [Law Concerning the Imposition of Wealth Tax], 3 Code fiscal art. 10 (exemption from inheritance tax between spouses where there are children from their marriage or these children have children, and, if an inheritance tax is levied between spouses, the amount subject to inheritance tax is reduced by Lux F 1,500,000).

[115]*See infra* sec. III(B), (C).

[116]*See supra* text accompanying notes 3 and 8, and *infra* text accompanying notes 132–42.

[117]*See* USA IRC §§ 2056(d), 2056A. However, double taxation is prevented if property is included in the estate of the decedent who transfers the property to a noncitizen transferee because upon the death of the transferee, the transferee's estate is given credit for the estate taxes paid by the transferor's estate. *See* USA IRC § 2056(d)(3). Parity with transfers to citizen spouses is not accomplished because in the United States there is an unlimited exemption for transfers to spouses, and if the transferee spouse consumed the assets received from the transferor, no wealth transfer tax would ever be paid.

In designing an exclusion for transfers to the spouse, the drafter must consider whether the transfer of a terminable interest (i.e., an interest that terminates with the death of the spouse) is eligible for the exclusion. Normally, it would not be, because the property with respect to which the terminable interest applies would not be included in the spouse's estate. In the United States, an exclusion has been extended to qualified terminable interest property, but the price of this exclusion is that the property must be included in the transferee spouse's estate upon the death of that spouse.[118] Such a rule mirrors the treatment for decedents with retained reversionary or income interests in property transferred during life.

Recognizing the hardship that occurs on the death of a parent, in the case of transfers at death, some jurisdictions provide a limited exemption for property transferred to minor children.[119] In some statutes, exemptions are provided for children regardless of age, although the amount of the exemption is limited.[120]

The problem of taxing too many transfers over a period of years because of other transfers to the same generation or untimely deaths in consecutive generations can be dealt with in a number of ways. The most common problem occurs when tax is paid on a wealth transfer resulting from a death, and this occurrence is followed within a relatively short time by the death of the transferee. Some statutes provide full or partial relief from taxation on the second transfer. Such relief is normally restricted to property included in the initial decedent's taxable estate.[121] One issue in designing such a scheme is whether the relief should be based on the tax payable on the first estate, the second estate, or on the lower of the two. The last would seem most logical in light of the purpose of avoiding double taxation, but the practices of countries differ.

In the United States, a credit is allowed for estate tax imposed on other estates with respect to all property that passed from such other estates to the decedent and that is included in the decedent's gross estate.[122] The statute provides

[118]*Id.* at §§ 2044, 2056.

[119]*See, e.g.*, JPN IHT art. 29-3 (exempt amount reduced with age up to age 20); DEU ErbStG § 17(2) (exempt amount reduced with age up to age 26).

[120]*See, e.g.*, NOR Aal. (children are granted a personal allowance of Nkr 100,000 for each child, with the next Nkr 300,000 subject to an 8 percent rate and the excess amount, 20 percent, while others are similarly allowed a Nkr 100,000 exemption, but the next Nkr 300,000 is taxed at 10 percent and any excess at 30 percent); ESP ISD art. 20 (exemption of Ptas 2,386,000 for descendants; increased exemption for descendants under age 21); PRT ISD art. 12(2) (limit applied to cumulative amounts received from the transferor); FRA CGI art. 779 (F 300,000 exemption for child); SVK INH (exemption for inheritance of immovable property up to maximum value of Sk 500,000 if the heirs are minors or are under 26 years old and are preparing themselves for their future profession).

[121]*See, e.g.*, USA IRC § 2013; JPN IHT art. 20; PNG WPA § 145; HKG EDO § 31 (relief limited to leasehold interest or business).

[122]*See* USA IRC § 2013(a). *See also* PNG WPA § 145 (providing for a reduction of net estate duty payable on property acquired from a deceased predecessor where deceased successor was a spouse, parent, child, grandchild, brother, sister, or spouse of a child of the deceased predecessor).

for a 100 percent credit for tax due on the property acquired from the transferor when the transferee dies within two years of the transferor and thereafter provides for a declining percentage of the tax owing on the property to be credited against the transferee's estate tax when the transferee dies within ten years of the transferor. Other countries provide for a reduction of estate duty payable on interests in immovable property or a business when the transferee dies within five years of the transferor.[123] If the value of the property has appreciated since the death of the first decedent, the reduction of estate duty is based on the value of the property at the time of the first decedent's death.[124]

At the other end of the spectrum, a comprehensive tax base should deal with generation-skipping transfers. This can be done through a separate tax on generation-skipping transfers or through a periodic tax on property held by entities.[125] Generation-skipping transfers of property are either direct skips of generations in the outright transfer of property or generation-skipping transfers that occur through the termination of a trust, foundation, or similar entity or a distribution of property held by such an entity.[126] A large exclusion is normally combined with generation-skipping provisions.[127] Thus, a generation-skipping tax would normally apply only to the largest estates. The mechanism for providing for the exclusion—an inclusion ratio—should not be determined when property is placed in trust at a time in which the generation-skipping tax does not apply, but should be determined at the time the generation-skipping transfer occurs.[128] Whether a transfer constitutes generation skipping should be determined at the time of the transfer, and the transfer should be valued at that time in applying the relevant exemption. Generation-skipping tax statutes require a definition of a skipped generation, which generally focuses on lineal descendants with a common grandparent; skips between unrelated persons can be defined with respect to age differences.[129]

[123]*See, e.g.*, HKG EDO § 31. The definition of business excludes a business carried on by a company.

[124]*See id.* § 31.

[125]While the United States uses the separate tax approach, it is an exception, and the more usual approach is to have no provision, or, as in the case of Germany, a periodic tax on property held in foundations or trusts. DEU ErbStG §§ 1(1), 9(1) No. 4. An indirect way of taxing generation skipping would be to tax transfers to more remote generations at higher rates than to closer generations.

[126]*See* USA IRC §§ 2611(a), 2612.

[127]*See, e.g.*, *id.* § 2631(a) ($1 million exemption per transferor).

[128]In the United States, the inclusion ratio is determined by allocating the exemption amount over the value of the property transferred. *Id.* § 2642(a). The fraction is set at the time of the transfer of property rather than when the generation-skipping transfer tax applies, and thus a significant appreciation in property can be sheltered when the generation-skipping transfer tax is triggered by either the termination of a trust or the distribution of property rather than by a direct transfer of the property to a "skip" person. However, direct skips of more than one generation trigger only one generation-skipping transfer tax, for example, a direct transfer from a great-grandparent to a great-grandchild.

[129]*See id.* § 2651.

Wealth transfer taxes often exclude from the tax base transfers disclaimed by the transferee.[130] The recognition of disclaimers is important to limit the amount of transfers subject to the transfer tax. Without recognition of the disclaimer, a second transfer tax would be imposed on the transfer to the ultimate beneficiary. Some statutes provide detailed rules on the time and manner in which the disclaimer must be made in order for the disclaimer to have the intended tax consequence.[131] The reason for such rules is to limit the use of disclaimers as a tax planning tool, whereby property can be transferred to the next generation free of transfer tax.

Drafters of any transfer tax statute must be cognizant of the property ownership regimes, forms of ownership, and rights upon death that apply in the particular jurisdiction and must tailor the statute accordingly. In countries in which property can be held jointly by spouses or family members with a right of survivorship and the joint tenancy of that property ceases upon death, the statute must be carefully drafted in line with the survivorship provision. Jointly held property could be included in full in the decedent's gross estate and then any exemption or other rate reduction relief could be applied to tax the transfer to the person who receives the property under the survivorship provision. Alternatively, jointly held property, such as under a tontine, in which the successive survivors among the joint owners obtain ownership of the property, could be presumed to be owned ratably by the joint owners during the time the property is owned jointly.

In civil law countries, it is common for the decedent's estate to vest directly in the heir, unless the heir makes a disclaimer.[132] As the debts and assets

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[130]Many civil code jurisdictions allow transferees to disclaim transfers. For example, under Italian law, the transfer of the decedent's estate to the heir does not take place automatically. Instead, it occurs only upon the acceptance of the inheritance by the heir. *See* Vittorio Tadei & Ugo Tribulato, *Italian Law and Practice, in* International Personal Planning 9/77 (Robert C. Lawrence, III ed., 1994). The acceptance may be express or tacit. *See* Civil Code, art. 474 (ITA). Similarly, French law provides that heirs may refuse the inheritance if they expressly mention the refusal in a register kept specifically for this purpose by the Tribunal de Grande Instance at the last domicile of the decedent. Paul Chamont, *French Law and Practice, in* International Personal Planning 7/69 (Robert C. Lawrence, III ed., 1994). Sweden has the same rule on disclaimers but rules that a disclaimer must be unconditional, not allowing the person to redirect the inheritance. Göran Englund & Christer Silfverberg, Beskattning av arv ochgäva, 65–70, 112–13 (10th ed., 1994). To be effective the disclaimer must, in other words, have the same effect on the distribution of the inheritance as if the disclaiming heir had been dead. (Disclaiming a legacy, of course, may have other consequences, depending on the conditions made in the will.)

[131]*See* USA IRC § 2518 (defining qualified disclaimer as an irrevocable and unqualified refusal by a person to accept an interest in property if the refusal is in writing and is received not later than nine months after the later of the date on which the transfer creating the interest is made or the day on which the person attains age 21 and where the person has not accepted the interest or any of its benefits).

[132]*See, e.g.*, Civil Code (ITA) (the estate is not treated as a separate legal entity under Italian law); Introductory Law to the Civil Code, arts. 25–26 (DEU) (under the doctrine of universal succession, all assets owned by the decedent are deemed to have transferred automatically and by operation of the law to the heir upon the decedent's death).

of the decedent in such cases automatically become the debts and assets of his or her heirs and legatees, the actual transfer of the estate of the decedent can be accomplished without an executor or administrator. As a result, an administrator is not typically appointed except in extraordinary circumstances.[133] In countries that follow the common law tradition, transfer of property is not automatic, and an executor or administrator is required to administer the estate and effect the transfer; typically, such persons are appointed under the terms of the will.[134] The practice of administering the estate as an entity and having the estate pay the inheritance taxes on behalf of the heirs and legatees also occurs in other countries.[135]

The choice between levying a wealth transfer tax on the transferor or the transferee will often turn on the manner in which property is transferred. Typically, transferor-based taxes have been adopted where, upon death, an executor takes charge of the estate. Transferee taxes are more congruent with a model in which there is no executor and property passes through a legal form of succession.

One aspect of a transferor tax that makes it somewhat simpler to implement than a transferee regime is that tax is levied on the entire amount of wealth transferred. This means that only a single calculation of the total tax base is required, to which the applicable tax rates are applied. Typically, only a single tax return is necessary. In contrast, a transferee tax is based on the special attributes of each recipient, requiring the calculation of separate tax bases and the application of rates for each base. The actual implementation of a transferee-based tax can rely, however, on using the transferor essentially as a withholding agent, requiring the transferor to calculate the tax due for each recipient and to remit the tax. If the substantive civil law concerning transfer

[133]*See, e.g.*, Civil Code, art. 528 (ITA) (the court may appoint an administrator while the estate is "vacant"); *id.* arts. 484, 491 (if the heir has accepted the estate "with benefit of inventory," the administration falls upon the heir).

[134]*See, e.g.*, Probate and Administration Act, ch. 251 (SGP). The executor will then petition the court for "probate," a term literally meaning "proving a will," and is in essence a grant authorizing the administration of the estate. In the absence of a will, upon the application for a letter of administration, the court will appoint an administrator. *See, e.g.*, Administration of Estates Act, § 18 (SGP). Responsibilities of an executor include ascertaining the decedent's assets and liabilities, paying the estate duty, collecting the assets, realizing sufficient assets to pay debts, and transferring the residue to the beneficiaries. Under many systems, executors may become personally liable for the tax due on the decedent's estate to the extent of the assets they receive or might have received but for their neglect. *See, e.g.*, GBR IHT § 204.

[135]*See, e.g.*, DEN INH. In most Nordic countries, especially Sweden, an executor administers the estate as an entity until it has been divided. *See, e.g.*, Englund & Silfverberg, *supra* note 130, at 13–14 & ch. 4 (Sweden). The inheritance tax is paid on the basis of the values at the time of the death. The listing of the estate and its valuation constitutes the basis for computation of the tax, and the estate pays the tax, either as an estate or on behalf of the heirs and legatees. The total tax on all the property is computed on the basis of a presumed division, and whether the heirs in fact deviate from the presumed division when actually splitting up the estate has no relevance in the tax computation. *Id.*

of assets at death allows, such a withholding system can greatly aid administration; this is particularly true when the recipient is a nonresident.[136] If the transferor fails to remit the correct amount of tax, a secondary liability will rest with the recipients. Also, executors can be held personally liable in certain cases.[137]

Legal persons and other entities can be either transferees or transferors of wealth. In a manner analogous to net wealth taxes, the holdings of legal persons can be attributed to physical persons, or the legal persons themselves can be treated as taxpayers. However, legal persons and other entities do not die. This makes it difficult to tax entities as a surrogate for taxing their owners. Some jurisdictions deal with this problem by taxing certain entities at regular intervals designed to approximate the life span of a generation.[138] To the extent that not all entities are taxed, a method of avoidance exists. However, in part because transfer taxes are levied relatively infrequently, they tend to have higher and more steeply graduated rates than yearly net wealth taxes. This may make it problematic to identify an appropriate tax rate to apply to entities that are taxed as a surrogate for taxing owners. Surrogate taxation tends to work much better under a net wealth tax with flat rates than under a transfer tax.

To prevent persons from avoiding tax by transferring their wealth to a nonresident entity in a jurisdiction where no wealth transfer tax exists, some countries with territorial systems have enacted statutory provisions that assess a tax on assets held by controlled entities if these assets were received from a resident decedent.[139] For example, in Hong Kong, if the decedent transfers property to a closely held corporation, a portion of the assets of the company is included in the decedent's estate, determined according to a formula based on the benefits accruing to the decedent from the company in the three years before death. The Hong Kong rules are highly complex and involve attribution rules to provide for deemed ownership for purposes of determining whether an entity is closely held.[140] Presumably, the complexity of the rules allows sophisticated tax planners to design transactions so as to avoid the rules, which thus largely serve as a trap for the unwary.

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[136]*See supra* text accompanying notes 132–35 & *infra* text accompanying notes 139–42.

[137]*See* SGP ED § 30(1)(an executor is not liable for any duty in excess of the assets that the executor has received or, but for the executor's own neglect or default, might have received).

[138]*See, e.g.*, the United Kingdom, which taxes trustees every ten years. GBR IHT § 64(the tax applies only to "settlements without interests in possession," for example, a discretionary trust in which no person has a present right of present enjoyment). The German term for such a tax is *Tote-Hand-Abgabe* and the French term is *main-morte*.

[139]*See, e.g.*, HKG EDO §§ 34–45; SGP ED §§ 18–19, 21. Under GBR IHT § 94(1), when a "close company" makes a transfer of value, a portion of such transfer of value will be treated as if it were made by each of the company's "participators." The company, however, will be primarily liable for the tax liability.

[140]*See* HKG EDO § 34.

In the case of a nonresident transferor, property held by a nonresident legal person is often untaxed under most rules.[141] If a valuation mechanism is in place to tax the value of the foreign shares attributable to assets within the country,[142] however, taxing shares in a foreign corporation with assets within the country may be a disincentive for nonresidents to invest in the country. A hybrid regime might be applied to tax a nonresident on wealth within the country or, if wealth is held through a foreign corporation, on an inheritance basis for inheritors who are residents of the country and who inherit the foreign shares. If an attempt is made to look through the assets of a nonresident legal person, then, as a drafting matter, provision should be made so that the rule cannot be avoided by using multiple tiers of entities.

Under an accessions regime, the use of entities and trusts becomes particularly problematic. For example, an accessions regime would require taxing transfers to trusts at creation rather than at distribution. Also, under estate and gift and inheritance regimes, another question arises: what is the appropriate value when the inheritor is a holder of a remainder interest rather than a life beneficiary? If the value used is that of the remainder at the time of the receipt of the remainder interest, significant wealth transfers escape taxation over the passage of time if the value of the underlying assets increases. One solution would be to revalue the assets of the trust at the time of transfer to reflect the changing relative values of the interests, either annually or periodically. If revaluation occurs only periodically, it should be performed at a minimum upon the death of the life beneficiary, and the difference in value relative to the value upon creation of the entity should be taxed. Difficulties arise in collecting the tax on the transfer to a nonresident trust.

B. Tax Base

Like that of the net wealth tax, the base of wealth transfer taxes usually includes all transferred assets of or to residents (depending on whether the tax is transferee or transferor based),[143] while the base of transferred assets of (or to) nonresidents is limited to those located within the jurisdic-

[141] *See* USA IRC § 2104(a).

[142] This mechanism would differ from an approach that directly taxes foreign investment in national property. For example, in the United States, a nonresident is taxed on the capital gain from the sale of U.S. real property or rights in U.S. real property as well as on the sale of shares in domestic corporations that are not publicly held, but that hold significant U.S. real property assets. The Foreign Investment in Real Property Tax Act does not directly apply to transfers of foreign shares in companies that hold U.S. real property assets, but the foreign corporation will be taxed on the gain if and when it sells the property. *See* USA IRC § 897.

[143] This course is followed in many countries, but many exempt foreign situs immovable property, and others also exempt foreign situs movable property.

tion.[144] Unlike net wealth taxes, the residency rules found in income taxes may be inappropriate for wealth transfer taxes[145] because the income tax residency rule is typically based on factors limited to a particular taxable year (such as presence for 183 days).[146] By contrast, wealth transfer taxes often take a long-run view of jurisdiction because they are imposed less frequently. Residence is often based on domicile. Individuals who have a domicile of origin in the country (because they were born there or their parents were domiciled there) or a domicile of choice (because they have established close connections with the country and have not shifted their domicile elsewhere) could be considered residents for transfer tax purposes even if they have a fiscal residence for income tax purposes in another country at the time the transfer tax is applied. The concept of domicile is generally more difficult to administer than the concept of residence used for income tax purposes, because it is based on an evaluation of a complex of factors and does not lend itself to objective, clear-cut determination.

C. Double Taxation

Because different jurisdictions apply different jurisdictional rules, both with respect to definitions of residence, situs of assets, and scope of the tax, the problem of double taxation of wealth may arise. To some extent, this matter can be addressed through treaty. Although less common than bilateral income tax conventions, some bilateral estate tax conventions do exist.[147] This ave-

[144]*See, e.g.*, USA IRC § 2103 (nonresident decedent's estate liable for tax on property located in the United States); GBR IHT §§ 5, 6 (nondomiciliary is liable for tax on assets located in the United Kingdom); Ireland Capital Acquisitions Tax Act 1976 (assets situated in Ireland are within the capital acquisitions tax, *see* Lynda A.M. Carroll, *Ireland: Inheritance and Gift Tax*, 34 European Taxation 374 (1994)); FRA CGI art. 750 *ter* (nonresidents pay tax only on property located in France); ESP ISD art. 7 (nonresidents liable for tax on property located in Spain and rights that may be exercised in Spain); Decree-Law 118/1973, arts. 3, 35 (GRC)(inheritance tax imposed on property of any kind located in Greece); Capital Transfer Act, § 1 (NOR) (transfer of assets of immovable property in Norway or property connected with a Norwegian permanent establishment is subject to tax). In developed countries, attempts have been made to tax nonresidents on property located in the country as well as residents on property worldwide. For example, in Ireland a person who receives property from an Irish resident or who receives property in Ireland from an Irish resident or nonresident is required to report the tax. In Germany, beneficiaries are taxed on receipts of property from German decedents and on receipts of property from nonresidents.

[145]*See generally*, J.F. Avery Jones, *supra* note 106, at 335–36.

[146]*See* vol. 2, ch. 18.

[147]*See* Jones, *supra* note 106, at 337–38. The OECD has published a Model Estate Tax Convention, which is the basis for many such agreements. *See generally*, Wolfe D. Goodman, *The OECD Model Estate Tax Convention*, 34 European Taxation 338–43 (1994). For the OECD model treaty, *see* Convention Between (State A) and (State B) for the Avoidance of Double Taxation with respect to Taxes on Estates and Inheritances and Gifts, August 31, 1989, Warren, Gorham, and Lamont, No. 1366–71. The OECD model, and the treaty networks of selected countries are discussed in International Bureau of Fiscal Documentation, *supra* note 11. The United States, which has numerous income tax treaties, as of 1995 has wealth transfer tax treaties with only 17 countries. As of 1995, approximately 13 treaties with France, including the treaties with the United States, Canada, Germany, Spain, the Netherlands, and Switzerland, deal with the French net wealth tax or contain provisions to determine the allocation of the tax.

nue is not likely to be relevant to most developing and transition countries, for which negotiating this type of treaty cannot be a top priority. Therefore, such countries would do better to provide unilateral relief to avoid double taxation.

To avoid problems with crediting transfer taxes paid outside the country, a developing or transition country could remove from the tax base for residents property that is subject to a transfer tax by another country,[148] and should ideally do so if the domestic tax rate is equal to or lower than the foreign tax rate. A number of countries exclude from the tax base immovable property located abroad, presumably on the theory that the property will be taxed abroad.[149] Of course, it may not be. Portugal and Hong Kong have a territorial system for both movable and immovable assets.[150]

Taxes on nonresidents should be imposed in a manner that ensures crediting of such taxes in the country of residence. For example, when a tax statute deviates from an accepted definition, it may be difficult to credit a tax paid on the tax base so defined.[151]

For taxes imposed on residents' property located abroad, the statute should provide a credit for foreign transfer taxes that are imposed on property abroad.[152] For example, if a wealth transfer tax resident dies holding property in a foreign country and that country levies a tax on the property, then the country of residence should allow a tax credit or, at a minimum, a deduction for foreign taxes. In addition, if lower governmental subdivisions of a national government impose transfer taxes, recognition of those taxes in the form of a full or partial credit against the national tax may be granted as a form of revenue sharing.

A foreign tax credit system for this tax will have to deal with the same issues as foreign tax credits for other taxes, namely, definition of the qualifying tax, definition of what property is located abroad, and an appropriate limitation rule.

D. Deductions

Several types of deductions are typically allowed in determining the net estate or net inheritance. In an inheritance regime or an accessions tax regime,

[148]*See, e.g.*, Hungary (Hungarian residents and legal persons having headquarters in Hungary are taxed on movable property and rights that can be sold and money or value inherited abroad if no estate or inheritance duties are payable in the country in which the property is located).

[149]*See, e.g.*, SGP ED § 2 (definition of "property").

[150]*See* PRT ISD art. 6; HKG ED § 19(b).

[151]*See infra* text accompanying notes 155–58, discussing the definition of the value of property by including debt on the property.

[152]*See* JPN IHT art. 21 (inheritance tax); *id.* art. 21-8 (gift tax); SGP ED § 28 (credit for estate duty paid to other countries in the Commonwealth but where duty is paid to countries not within the Commonwealth, an allowance in the amount of the duty is made from the property value); PNG WPA § 156(1).

these deductions are implicitly allowed because the tax is based on the net amount received, although limitations on some deductions may be imposed.[153]

Expenses of administering the estate are typically deductible. Administrative expenses include executor's commissions, legal fees, investment banker fees, valuation expenses, and in general any other expenses incurred to manage or conserve the estate, rather than being incurred for the benefit of a beneficiary.[154] The criteria for deductibility of administrative expenses should be carefully defined so as to avoid disputes. Often, the definition refers to standards used by courts for purposes of supervising administration of the estate, but these may not in all cases be appropriate for tax purposes. Administrative expenses should be limited to those that are reasonable in amount to prevent an executor from siphoning off funds to relatives for performing services. Thus, executor's commissions should be limited by statute or regulation. Furthermore, the statute should explicitly provide for the denial of deductions related to exempt property transfers.

The cost of a decedent's funeral is normally deductible. Debt is often[155] but not always[156] deductible in determining the tax base. If debt is deductible, nonresidents who own property within the country can mortgage the property so as to reduce its net value.[157] The problem of debt finance is endemic to any wealth transfer tax system that seeks to reach the property of a nonresident within the country. An antiabuse rule ought to apply. One alternative is a presumption that debt is used to limit the tax base, with the decedent or the estate bearing the bur-

[153]*See* DEU ErbStG § 10(5).

[154]For example, in some countries, a commission incurred on a sale of property may not be considered an administration expense unless the will directs the executors to sell the property.

[155]In France, Greece, and Portugal, debt is deductible in full if due by the decedent on the date of death and evidenced in writing, and in Italy if the property to which the debt relates is included in the taxable estate and the debt is proved by an officially dated document. *See* FRA CGI arts. 768–74; Decree-Law 118/1973 arts. 21–23 (GRC); PRT ISD arts. 27–29. In Norway, Spain, Sweden, the United Kingdom, the United States, and Switzerland, debt is also deductible, but some Swiss cantons limit debt to property that is taxed in the canton. *See* International Bureau of Fiscal Documentation, 34 European Taxation 397, 407, 412, 414, 416, 424, 428 (1994); USA IRC §2053(a)(4).

[156]While debt is normally deductible, in Belgium, debts in the form of mortgages and liens on immovable property located in Belgium are not deductible. *See* International Bureau of Fiscal Documentation, *supra* note 155, at 348. In Denmark, debts of the decedent to the decedent's spouse, children, and other descendants are deductible only if real value has been received. *See id.* at 351. In Finland, debts secured by immovable property outside Finland and debts related to nontaxable property are not deductible. *See id.* at 356. In Venezuela, debts are not included if declared and recognized in the will or shown in documents privately signed by the principal when no other evidence exists to verify them, nor are debts originating or executed outside of the country unless originated for investment purposes within the country unless the external debt is guaranteed with pledges or mortgages on property located abroad. *See* Inheritance and Gift Taxes Law, art. 26 (VEN).

[157]For example, widespread fraud in the transfer tax regime with respect to false claims of debt against the decedent's property prompted repeal of the largely flawed and unadministrable transfer tax in Mexico.

den of showing that the property had to be financed out of borrowed funds. A less onerous approach would be to allocate the debt ratably over the value of all of the decedent's property. This would be less arbitrary than having the statute disallow the deduction for debt for nonresidents. Or, the statute could stipulate that no deduction is allowed for debt that is either incurred or unilaterally recognized within a certain period before death.[158] The important concern is to show that the decedent would receive cash or assets for the debt.

Income taxes on the decedent's income should be deductible from the tax base as a debt of the estate. If a credit for estate taxes paid in foreign jurisdictions is not allowed, then a deduction for these taxes should also be allowed as a debt of the estate.

A deduction for transfers to charitable beneficiaries, including religious organizations, is often allowed. The theory is that the property will be devoted to public purposes. Also, under an inheritance tax regime, no individual receives an inheritance when property is transferred to charity. Nonetheless, charitable transfer exemptions raise several policy issues. These include the location of the charity, the definition of eligible charitable recipients, and the taxation of partial transfers to charities. With respect to partial transfers to charities, tax benefits that arise from both charitable lead trusts and charitable remainder trusts should be properly valued in determining whether and to what extent partial transfers to charities should be allowed.[159] For example, if a transfer is made to a charity for a term of years with remainder to the transferor's family, under certain actuarial and investment assumptions, the entire amount of the property would be deemed to be transferred to the charity even though after the passage of time significant assets would be available for distribution to the family members and the transfer would avoid all wealth transfer taxes. This result can be avoided by specifying appropriate valuation rules.

While some countries allow a deduction for transfers to both local and foreign charities,[160] others limit the deduction to local charities.[161] A developing or transition country can generally limit eligibility for the deduction to charities in the country so that the benefits of the charity will accrue locally. There may be some exceptions, however, particularly for immovable property located abroad. In such a case, the property will typically be used by a charity for its charitable purposes, and it might be impossible to find a domestic charity interested in using the property.

[158]Belgium and several other countries have such a rule. *See supra* note 156. The unilateral recognition of debt could also be treated as a gift. Nonetheless, a possible mechanism of avoidance still occurs if the decedent incorporates activities and has the company incur the debt, thereby reducing the value of the corporate shares. Therefore, a look through rule would be necessary to police any form of abuse in valuation through the use of debt.

[159]These also raise issues under the income tax deduction for charitable contributions.

[160]*See, e.g.*, USA IRC § 2055(a)(2).

[161]*See, e.g.*, CZE IHT (exempts legacies left to religious, cultural, educational, scientific, health, social, ecological, or sports institutions).

E. Exclusions

The decision whether to include life insurance in the tax base involves several considerations. First, if the decedent had not died, then he or she would have had the opportunity to transfer value to the heirs in a form that would not be subject to transfer taxes (e.g., by allowing them to share in favorable business opportunities). To the extent that insurance compensates for this lost opportunity, the proceeds should arguably be excluded. Second, when the insurance proceeds represent the value of a person's human capital that would have been consumed during life, it is arguably unfair to include the life insurance in a transfer tax base. This argument does not apply to the portion of the life insurance proceeds that represents more than that.[162] On the other hand, the argument for including life insurance proceeds is that they represent a transfer of wealth. The fact that the transfer may have been smaller under other circumstances does not mean that the tax should not apply. Moreover, excluding life insurance can lead to problems of defining rules to prevent abuse.[163] In countries where life insurance is excluded from the gross estate, there is generally a requirement that the estate not be a beneficiary of the policy and that the decedent have not possessed within three years of death any incidents of ownership over the policy, such as the right to change beneficiaries or borrow on the cash surrender value of the policy. Such provisions complicate administration, but may be needed to prevent abuse of a rule that excludes insurance.

If life insurance receives special treatment, then the issue arises as to how to define life insurance. In the United States, complex definitions apply to both the income tax and the estate tax.[164] That complexity would apply in any tax system that differentiates between life insurance and other assets, such as annuities, that are generally included in the decedent's estate. Moreover, if the statute exempts from estate taxation a certain amount of life insurance, then it can be argued that the same amount should be allowed as an exemption for annuities arising from death benefits payable on the basis of the decedent's pension and retirement rights when the decedent does not have life insurance. As set forth above, there is little rational basis for excluding life insurance, annuities, or death benefits. Moreover, annuities and death benefits represent

[162]This would include the capital cost of the insurance policy (together with an investment return on this capital), as well as the amount that represents compensation for human capital that could have been expected to have been converted to property and passed on to the heirs.

[163]*See* USA IRC § 2042 (proceeds of life insurance passing to estate or in which the decedent possessed an incident of ownership at the time of death are included in the estate, but proceeds passing directly to other beneficiaries are excluded); SGP ED § 8(f)(property passing on the death of the deceased includes insurance proceeds where the policy is kept up by the decedent); NZL EGD § 14 (abolished 1992) (gross benefits payable on a life insurance policy are includable in dutiable estate if beneficial interest in policy is disposed of within three years of death); JPN IHT §§ 3, 12(5) (insurance proceeds includable in taxable estate with reference to portion of premiums paid by decedent, but limited exemption available).

[164]*See* USA IRC § 7702.

pre-existing wealth (e.g., deferred compensation), and the rationales for excluding life insurance do not apply to these other items.

Many countries have special provisions for agricultural properties.[165] To the extent that agriculture is treated as a special asset based on public policy grounds of encouraging small agricultural holdings, a good definition of property used for agricultural purposes is required, as is an antiabuse rule aggregating holdings of agricultural property to prevent splitting such ownership among numerous persons to avoid the tax. One approach is to subject all agricultural property to tax, but to impose a lower rate on such property. Another is to assign to agricultural property the value it has in agricultural use, as opposed to the higher value it may have for development. To qualify for the lower valuation, the property would be valued for its agricultural use with the requirement that it remain in agricultural use for a specified period of time.[166] All such rules complicate the tax law. The preferable solution is not to adopt any special rules and to rely on the general exemption to protect small holdings.

Some countries exclude from the wealth transfer tax base subsistence assets, such as small (and often large) businesses,[167] a home, and the decedent's personal effects.[168] Because of difficulties in defining such subsistence assets, a

[165]*See* JPN IHT § 26-2 (standing timber valued at 85 percent of market value); SVN TC (full exemption for farmers on land); Serbia and Montenegro Taxes on Property Act of 1992, *noted in Taxation and Investment in Serbia and Montenegro*, 5 Taxation and Investment in Central and Eastern European Countries § 9.2.3 (Apr. 1995 Supp.) [hereinafter Taxation & Investment] (exemption for inheritance of property used for agriculture by a farmer in the second order of succession to the deceased or donor, provided the person lived in the same household with the deceased or donor for at least five years); USA IRC § 2032A (special valuation for real property used in farming or business; continuing use requirement); GBR IHT §§ 115–16, 124A (value of agricultural property is generally reduced by 50 percent; continuing use requirement).

[166]*See* USA IRC § 2032A.

[167]Several countries exempt businesses from transfer taxation. *See, e.g.*, CZE IHT (business property exempted); Perint jalahjaverolaki (Inheritance and Gift Tax Law) No. 378/1940 of July 12, 1940, as amended, § 63a–c (FIN) (partial relief from inheritance or gift tax where a farm or business enterprise is passed to the next generation); GBR IHT § 104 (50 percent reduction in taxable value for a business).

[168]*See* SGP ED § 14 (value of dwelling house excluded, up to a specified amount); PNG WPA § 134(1)(e) (exclusion for joint ownership interest in the matrimonial home); HKG EDO § 10A; Serbia and Montenegro Taxes on Property Act of 1992, *noted in Taxation and Investment in Serbia and Montenegro*, 5 Taxation & Investment, *supra* note 165, § 9.2.3 (Apr. 1995 Supp.) (exemption for inheritance of apartment by person in the second order of succession to the deceased or donor provided the person lived in the same household with the deceased or donor for at least one year); Russia Law of Dec. 12, 1991, *noted in Taxation and Investment in Russia*, 5 Taxation & Investment, *supra* note 165, § 9.4.3 (July 1993 Supp.) (home or apartment exempt); *Taxation and Investment in Romania*, 5 Taxation & Investment, *supra* note 165, § 9.2.3 (Apr. 1994 Supp.) (50 percent of value of home not taxed if property was used exclusively by decedent and the decedent's family, the heir was living with the decedent at time of death, and the inherited property does not include borrowed personal property).

better approach is to provide a broad exemption from tax for a certain value of property. However, if specified property, such as a residence, is excluded, the amount of the exclusion should be limited.

Certain countries treat cultural property favorably.[169] This raises questions of horizontal equity as well as definitional questions as to what property should be subject to such protection. To the extent that a country allows a charitable contribution deduction for transfers of property to either the government or a charitable organization, the protection of cultural property in this manner for the public benefit is encouraged. Exemptions for cultural property that permit the property to remain in family ownership can be difficult to administer.

F. Valuation

Valuation is a key issue for wealth transfer taxes and one that involves considerable difficulties. The basic problems are that property transferred is often unique, and there is no arm's-length transaction to establish a price. These problems are shared with the net wealth tax, discussed above.

For estate and inheritance regimes, the statute should provide that the valuation of the property is determined as of the date of death. Some statutes provide for an alternate valuation date based on a set time after the decedent's death.[170] Some statutes take other approaches to valuation problems caused by the fortuitousness of death in a changing market.[171] At the price of some complexity, the availability of an alternate valuation date helps to minimize such problems. An alternate valuation date must be elected generally for all assets.

One way of limiting the amount subject to an estate or an inheritance duty is to use techniques that freeze the value of property. Freezing techniques include converting common shares into preferred shares, thereby limiting their future appreciation. In some countries, freezing techniques have been

[169]*See, e.g.*, SGP ED § 15 (the tax commissioner may choose to remit the estate duty payable in respect of books, works of art, and so on if the commissioner finds them to be of national or artistic interest and if they are given for national purposes or to a university).

[170]*See, e.g.*, USA IRC § 2032 (allowing the executor to elect to value the gross estate based on a valuation date six months after the decedent's death if it will result in a reduction of tax). Often, property is valued based on the date it is sold if within one year of death. In contrast, some countries take the approach of providing the tax authority discretionary power to determine the appropriate value of the property transferred if there has been depreciation of value due to the death of the decedent, which might occur for example in the case of a closely held business. *See* SGP ED § 24(3). As with all discretionary provisions, the latitude given in tax administration should be circumscribed.

[171]*See* SWE AGL 23 A7 B, 4th para. (provides for an adjustment if a sale under normal circumstances cannot be expected to return a price corresponding to the market quotation on the date of death) (rule enacted as a response to a particular case).

dealt with by statute.[172] A developing or transition country can instead provide a bright line rule that a preferred interest that is created from a common interest shall be deemed to have a particular rate of return attributed to it for the purpose of estate tax or inheritance tax valuation. Moreover, retained controls over property should be dealt with consistently over different types of entities; that is, a retained control that would be impermissible with a trust should not be allowed with a partnership or corporation.

Inflation, even high inflation, does not pose major problems for wealth transfer taxes, provided that a few relatively simple adjustments are made. Whether these are required will depend primarily on how high inflation is expected to be. One adjustment that may be appropriate is to the rate brackets and any other items expressed in national currency. The most appropriate mechanism would be to use any inflation adjustment mechanism under the income tax or, if one is not available, to provide for one in the inheritance or estate tax schedule.[173] The extent of the collection lag problem[174] will depend on the inflation rate and the length of time between the occurrence of death and the time the tax is due. Often, substantial time is allowed. In such a case, consideration should be given to shortening the time period or indexing for inflation the amount of tax due. Finally, an inflation adjustment may be required if there is an integrated gift tax. For example, when there is a lifetime unified credit for estate and gift tax purposes, the amount of unused credit should be adjusted for inflation each year. Such inflation adjustments should also apply to any annual gift tax exclusion. Similarly, for an accessions tax, cumulative lifetime accessions will have to be adjusted for inflation in order to apply the rate schedules.

G. Rate Schedule and Exempt Amount

The rate schedule to be established for an estate or an inheritance tax as well as for an accessions tax should take into account both an exempt amount and graduation in the rates.

Estate taxes invariably provide a general exemption, deduction, or nonrefundable credit against tax. Usually, the amount of the estate that can pass free of tax is substantial, the policy of the tax being to reach only the largest concentrations of wealth. Thereafter, the estate is commonly subject to graduated rates, although sometimes there is a flat rate of tax after the application of a broad exemption.[175] A similar regime exists with respect to inheritance taxes, where there is an exemption and a graduation of rates, often depending

[172]USA IRC §§ 2701–704. In addition, split-interest transfers pose valuation problems that can also reduce the tax base.

[173]*See supra* ch. 13. The same type of adjustment should be made for the net wealth tax.

[174]*See id.*

[175]*See, e.g.*, GBR IHT sched. 1.

upon the consanguinity of the decedent from whom the individual has received a bequest,[176] reflecting a policy that bequests from persons who are more distantly related should bear a higher tax.[177] Under many regimes, bequests from spouses bear either no tax or a reduced tax.[178]

H. Administration

Under an estate tax regime, only one tax return is filed. More reporting may be required under an inheritance or accessions tax, although provision is generally made for an estate to file a single return that reflects the separately computed taxes on the shares of the various beneficiaries.[179] The tax identification numbers of recipients of property from the estate and of the estate itself should be included on the return. A filing deadline should be fixed within a particular time after death, such as six months. Small estates and inheritances should be exempt from filing because it would not be feasible for taxpayers or the tax administration to require reporting for all transfers.[180] Family law in many countries provides for a listing and valuation of all estates, even for the absolute poor. These listings can be used for inheritance tax purposes.

Payment of tax would appropriately be required on the due date of the return. Special provisions can be made for extending the time of payment with an appropriate interest charge in the case of hardship, such as when the estate is primarily composed of illiquid assets (e.g., agriculture or small businesses). Eligibility for extended payment can be stated in terms of a mechanical rule based on the composition of the estate.[181] The statute should not be drafted to delay the tax until the asset is sold because such a provision would cause a severe lock-in problem, unless interest is charged.

Some countries allow payment in kind of estate duties through the transfer of cultural property.[182] An estate tax payment could also conceivably be made through the transfer of other property that the country would deem appropriate, such as a scenic easement over property to preserve the natural environment.

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[176]In a typical regime, the inheritance and gift tax regime of the former Yugoslav Republic of Macedonia exempts transfers received by children from their parents or by spouses ("first-order heirs"), but taxes transfers to second-order heirs, for example, siblings and grandparents, at a 5 percent rate (although under certain circumstances exemptions also apply), and taxes transfers to third-order heirs, for example, cousins, aunts, and uncles, at a 10 percent rate. *See* MKD PPT § 14.

[177]*See supra* note 125.

[178]*See supra* notes 111–18 and accompanying text.

[179]*See supra* text accompanying notes 132–35.

[180]For procedures on assessment and collection of the tax, *see* Inheritance and Gift Taxes arts. 36–45 (VEN).

[181]*See, e.g.*, USA IRC § 6166.

[182]*See, e.g.*, GBR IHT § 230 (works of art are accepted in satisfaction of tax); FRA CGI § 1716 *bis*; Ann. II § 384A (works of art, books, collectibles, or documents with a significant historic or artistic value may be used to pay the inheritance tax if the government agrees).

The statute should address the manner in which probate assets are transferred and require a certification that the estate tax has been paid before the transfer of assets, such as immovable property listed on a registry, can be recorded.

I. Gift Tax

The most straightforward estate planning technique for minimizing estate tax is to make lifetime transfers of property. However, taxpayer clients often do not take full advantage of this opportunity because it requires them to part with property, something that the type of taxpayer who has estate tax problems generally does not like to do. For those willing to plan, lifetime gifts can substantially erode the base of a transfer tax imposed at death. An integrated gift tax is therefore necessary to prevent avoidance of the estate, inheritance, or accessions tax. With an integrated gift tax, the property will either be taxed under the estate or inheritance regime or under the gift regime.

Property transferred by gift is valued as of the date of the transfer. For purposes of determining the amount of the taxable gift, the amount of the gift should be grossed up by the amount of the tax to provide parity with an accessions and estate tax, but this is not always done.[183] Moreover, because the tim-

[183]In some gift tax systems, such as in the United States, the tax is computed only on the net amount that actually passes to the beneficiary. This is true regardless of whether the donor or the donee pays the gift tax. If the donor pays the tax, the tax is simply calculated on the value of the property that actually passes to the donee. A donee who agrees to pay the tax is considered as relieving the donor of liability and as giving partial consideration for the gift, which reduces the amount of the gift that is subject to tax. Thus, the tax is calculated on the net gift amount received by the donee rather than the grossed-up amount, regardless of who pays the tax. The only exception in the United States on the failure to gross up is in the case of lifetime transfers made within three years of the transferor's death. Both the gift and the gift tax paid are brought back into the donor's estate. *See* USA IRC § 2035(c), (d).

The failure to gross up is significant. If a person's estate is subject to an estate tax of 50 percent, then the beneficiaries and the government will each receive one-half of the available estate. If a gift is taxed at a rate of 50 percent without grossing up, then of the total amount transferred by the donor (gift plus gift tax), the beneficiaries get two-thirds and the government gets one-third. Thus, there is an incentive for lifetime giving.

Other countries have adopted rules requiring a full grossing up of lifetime gifts. For example, in the United Kingdom, the value transferred is the difference between the value of the transferor's estate before and after the transfer. When the transferee pays the tax on the gift, the value transferred is the full amount of the gift with no reduction for tax payable by the transferee. When the transferor pays the tax, her liability for tax on the value transferred is taken into account in determining the value of her estate immediately after the transfer so that the amount subject to tax includes both the amount of the transfer to the beneficiary and the gift tax due on the gift. *See* Gift Tax Act, ch. 7 §§ 19(1), 20(2), 38, sched. 10, para. 1(1)–(2) (GBR). In Germany the inheritance tax is generally applied on a tax-inclusive basis, the transferee being liable for the tax. If the donor or testator pays the inheritance tax, then this amount is added to the taxable amount of the inheritance. *See* DEU ErbStG § 10(2). However, there is an incomplete grossing up in that the tax on this amount is not taken into account, thereby leaving some advantage to the assumption of tax by the donor. *See* Jens Peter Meincke, Erbschaftsteuer- und Schenkungsteuergesetz Kommentar 340 (10th ed. 1994).

ing of a tax is important, there must be definitions with respect to when taxable property transfers occur. Several countries address this issue directly in the statute,[184] while others deal with it through judicial interpretations of the law. As noted below, some statutes include gifts in the taxable estate if they are made shortly before death. Two approaches compatible with a gift tax system are to cumulate inheritances with gifts that have been previously received from the deceased,[185] or to tax gifts under an inheritance or accessions regime.[186]

1. *Inclusion of Certain Gifts in Taxable Estate*

Often, statutes provide that transfers shortly before death will be subject to death tax if a decedent surrenders, whether or not for value, her or his right to receive any benefits from property in which the decedent has retained an interest or transfers property within a certain period before death. Generally, such transfers will be treated as not having been made for death tax purposes if made within three years of the decedent's death.[187] Thus, estate and inheritance tax statutes include transfers in which the decedent has a retained interest, transfers made within three years of death, or property where a decedent transfers a retained interest within three years of death. In some countries, the time period for gifts made in contemplation of death is less than three years.[188] The reason for inclusion is that the valuation difference that can occur for gift and estate tax purposes. When property is included in the estate and has also been subject to gift tax, the amount of the gift is not added back, but the full value of the property at the time of death is, with credit given for any previous gift tax paid. Moreover, the amount of the gift tax paid is also added back to the gross estate.

2. *Definition of Gift*

Most statutes define a gift as occurring when, without consideration or for inadequate consideration, one person transfers property to another,[189] dis-

[184]*See, e.g.*, USA IRC § 2501(a)(7); DEU ErbStG § 9.1 No. 2; Gift Duty Assessment Act, 1941-73, § 12 (AUS)(abolished 1979) (specifying when a gift is deemed to be made).

[185]For example, Chile's inheritance tax operates in part as an accessions regime with respect to gifts or inheritances from the same donor. *See* CHL IHAD art. 23 (consolidations of gifts and bequests made by the same donor to the same transferee for purposes of applying the progressive gift or inheritance tax rates).

[186]This is somewhat the approach that has been adopted in Ireland. *See* Capital Acquisitions Tax, 1976 (IRL); Inheritance and Settled Property Tax, 1993 (IRL). The Irish inheritance tax regime has recently been supplemented with a 2 percent probate tax on estates.

[187]*See* HKG ED § 37(3); SGP ED § 8(c)(five-year period); JPN IHT art. 19; PNG WPA § 134(1)(d)(i).

[188]For example, in Venezuela immovable property that at the time of the beginning of the estate has been sold by the principal by documents not registered in the public register is included in the estate, except for sales shown by authentic documents authorized at least two years prior to death. Assets sold for a consideration in the year prior to death to any person who is a legal successor are also included in the decedent's gross estate. *See* Inheritance and Gift Taxes Law, art. 18 (VEN).

[189]*See, e.g.*, USA IRC § 2512(b); DEU ErbStG § 7.1 No. 1.

charges the other person from a debt or other contractual obligation, or releases an actionable claim.[190] Furthermore, a person will be deemed to have made a gift by causing title to property to be vested in her- or himself and another person jointly without adequate consideration.[191] Some statutes expressly exclude from the definition of "gift" any property passing by will[192] and gifts *causa mortis*,[193] both of which would be taxed under the estate or inheritance tax.

At least one country taxes gifts made by a controlled company[194] where the transfer is (1) to or for the benefit of any person related to the controlling person, or (2) to any company that is under the control of a person related to the controlling person.[195] In some countries, corporations have been held directly liable for gift tax.[196] In the United States,[197] the regulations make clear that gifts to corporations are gifts to the individual shareholders and that gifts from corporations are gifts from the individual shareholders. A better drafting approach would be to deal with such transactions in the statute rather than in regulations.

3. *When a Gift Is Complete*

The issue of when a gift is complete assumes increasing importance to the extent that the transfer tax system falls short of integration, that is, when it fails to provide equivalent treatment for lifetime gifts and transfers at death. As a policy matter, a perfectly integrated system, which would eliminate questions of completion of gifts, would be preferable. Furthermore, uniform valuation rules would also solve problems with valuation distortions through split-interest gifts and gifts by which the grantor retains an income or other interest.

[190]*See, e.g.*, USA IRC § 2511; DEU ErbStG § 7.1 No. 2; Gift Tax Act, 1958, §4(c) (IND); Inland Revenue Act, 1980, § 53(d) (LKA) (abolished 1993).

[191]*See, e.g.*, Gift Tax Act, 1958, § 4(d) (IND); Inland Revenue Act, 1980, §53(c) (LKA) (abolished 1993).

[192]*See, e.g.*, NZL EGD § 2(2).

[193]*See, e.g.*, Gift Tax Act, 1958, § 5(xi) (IND); Inland Revenue Act, 1980, §54(h) (AUS) (abolished 1979).

[194]In New Zealand a controlled company is defined as "any company that, at the time when the disposition of property is made, is controlled by or on behalf of any one person (in this section referred to as the controlling person), whether directly or indirectly, and whether through holding a majority of the shares in the company or in any other company, or in any other manner whatever." NZL EGD § 65(1).

[195]*Id.* § 65(2)(a)–(b). Payment of the gift duty assessed by the donor-controlled company, however, does not constitute an additional gift. *Id.* §65(2), at 273.

[196]In Sweden closely held corporations have been held liable to gift tax when they have received undervalued property and the court has found that those directing these operations have intended to benefit the owners of the recipient corporation. Christer Silfverberg, *Gäva till aktiebolag ur inkomst-och voskattesynvinkel*, 1993 Skattenytt 693–701.

[197]Treas. Reg. § 25.2511-1(h)(1) (USA).

The following transactions give rise to issues of whether gifts are complete. First, gifts made within a certain period prior to death often appear to be substitutes for testamentary transfers and may be made in an attempt to benefit from the less comprehensive or reduced tax on lifetime giving.

Second, in some countries, a gift is treated as presently effective when made even though the gift has strings attached to it.[198] For example, a transferor may reserve to her- or himself the right to possess or enjoy the property or receive the income from it for the transferor's life or some other period that has not yet expired when the transferor dies. In the United States, this type of transfer would result in an immediate gift tax on the remainder interest. Moreover, the entire value of the property including the remainder interest would be included in the transferor's estate when she or he dies.[199] Thus, the United States makes it hard to complete a gift when the transferor maintains a beneficial interest in the property transferred. The United Kingdom also has a hard-to-complete rule for transfers when the transferor retains an income or enjoyment interest. In addition, a U.S. rule stipulates that a transfer under which the transferor can no longer enjoy the property but where she or he can exercise some control over who will enjoy the property does not constitute a completed gift.[200] The alternative is to have a rule such as in the United Kingdom whereby, if a transferor retains control over the enjoyment of transferred property (excluding enjoyment of the property by the transferor), the transfer would normally be the creation of a "settlement" of property with no interest in possession, and a tax would be collected at the time of the creation of the settlement. A statute treating such a settlement as a gift must take into account the valuation of property and the consequences of the grantor's changing the disposition of the property.

Third, revocable transfers do not result in a completed gift. Thus, revocable transfers of property result in the inclusion in full of the value of the prop-

[198]Inland Revenue Act, 1980, § 53(e) (LKA) (abolished 1993) ("the gift of any property subject to a reservation in favor of the donor or any other person shall be deemed to take effect when it is made and not when the interest created by the reservation is extinguished"). The statute does not define "reservation." Presumably, it refers to a life estate retained by the donor or a life estate created by the donor in favor of another. However, absent a precise definition, it could also be construed to mean a reservation in the donor of a power to revoke the gift or to change the persons entitled to possession or enjoyment of the gift (if, for example, the gift was in trust). Hence, the gifted property could potentially be subjected to double taxation since the gift duty would be assessed on a gift that was incomplete when it was made, and the estate duty would be assessed at the donor's death since the donor effected a transfer with retained powers.

[199]*See* USA IRC § 2036(a)(1).

[200]Thus, if the transferor retains the right to designate who can enjoy the property she has transferred, or if the transferor can change the enjoyment of the property through a power to alter or amend the terms of the prior transfer, no taxable gift occurs. *See* USA IRC §§ 2036(a)(2), 2038(a)(1). *But see* Commissioner v. Warner, 127 F.2d 913 (9th Cir. 1942) (gift occurs if the beneficial interests have become fixed with respect to who is entitled to the property, so that the transferor has retained control only over the timing of the enjoyment). Where the retained interest is in the nature of a remainder, the statute adds back only the value of the remainder interest that is held by the decedent.

erty in the decedent's estate because revocability indicates continuing dominion and control over property.[201] Issues arise as to whether powers that may be exercised under a standard such as the health, maintenance, and support of a beneficiary constitute a retained interest. A simple rule would stipulate that the donor will be treated as retaining an interest when discretion exists as to the payment of proceeds. This would encourage the use of third-party fiduciaries but would perhaps increase costs for smaller estates. Life insurance is a common example of property in which the transferor commonly retains an interest, because the owner of the policy can normally change the beneficiary unless she or he expressly gives up this power.

Fourth, retained powers to withdraw property from a trust should be treated the same as a retained power to alter the beneficial enjoyment of the property. Failure to do so creates a method for avoidance.[202] Fifth, transfers taking effect at death may mean that if a beneficiary can obtain possession or enjoyment of property only by surviving the donor, then the property will be included in the donor's estate. Notwithstanding this inclusion, the property transferred subject to the survivorship requirement is a taxable gift of the contingent interest. A *de minimis* rule may also apply, to allow minimal interests to be disregarded.[203]

4. *Jurisdictional Issues*

Jurisdictional issues are the same as for taxes on transfers at death, except that the administrative problems of identifying taxable gifts are greater because there are many more potential donors in any given year than there are decedents. A comprehensive gift tax regime should apply to all gifts of property, wherever located, to and from residents. This principle is difficult to apply, especially when the recipient is a nonresident. Gifts of property within the country to nonresidents should also be included within the base. There are obvious difficulties with collection of the tax in such cases.

5. *Integration with Estate, Inheritance, or Accessions Regimes*

A gift tax should be integrated with the estate or accessions regimes. An integrated regime involves a cumulation of lifetime gifts and transfers at death for purposes of applying the graduated rate schedule. Under an integrated re-

[201] *See* USA IRC § 2038.

[202] In the United States cases make a distinction between a retained power and a right to invade the corpus and make withdrawals, with the latter power not treated as a retained power. *See* Estate of Kisling v. Commissioner, 32 F.3d 1222 (8th Cir. 1994) (holding that the terms of a trust permitted the decedent to invade the corpus and make withdrawals without terminating the trust where the exercise of the powers to make transfers of the withdrawn assets was treated as distinct from powers over the remaining trust corpus).

[203] For example, in the United States if the donor's retained reversionary interest has a value of 5 percent or less of the value of the property immediately before death, the property will not be included in the donor's estate. *See* USA IRC § 2037(a)(2).

gime, it is not necessary to provide that gifts made within a specific period before death are included in the estate or inheritance tax regime as is done in some countries.[204] Such inclusion is redundant and complicates administration unnecessarily. However, under certain circumstances, the failure to add back gifts made within a certain period before death limits the total amount of the tax collected.[205]

6. *Exemptions*

Many gift tax regimes deal with small gifts by granting the donor an annual gift exemption.[206] This exemption can erode the tax base.[207] At a minimum, one should consider making the amount very small or putting a cumulative cap on the total amount of exempted gifts. The small gift rationale is based on the administrative concern that it is difficult to monitor certain transfers of property that are usually of a small value. Under that view, there should be no exclusion for any gift of registered property, including life insurance, because in these cases there are public records of transfer.

The annual exemption is generally expressed in terms of the gift of a present rather than a future interest in property. Complications arise in distinguishing between present and future interests. If a legal but somewhat illusory right is given to the beneficiary of a future interest to claim a present interest in property, the amount that could have been claimed may be treated as a transfer of a present interest for purposes of the exclusion.[208] Therefore, a well-drafted statute should limit the right to the annual exclusion to actual transfers of a present interest. A simplified form of drafting the statute would eliminate from the annual exclusion any transfers in trust.

Gifts made for the maintenance or education of the donor's relatives are generally also exempt.[209] A definition of support needs to be provided in the

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[204]*E.g.*, USA IRC § 2001.

[205]Sales of property by the estate of a celebrity are a perfect example. The property gifted before death would presumably have a transfer tax value based on the fair market value of such property, which may or may not have an increased value due to the celebrity status of the owner. However, after death the same property may have an increased value because of the celebrity status of the owner, as is illustrated by the auction experience in the United States with the estates of Rudolf Nureyev and Jacqueline Kennedy Onassis.

[206]*See, e.g.*, NZL EGD § 71 ($200 annual exemption per donee); USA IRC § 2503(b) (referred to as annual exclusion).

[207]For example, in the United States, a husband and wife may give $20,000 a year each free of gift tax. *See* USA IRC § 2503(b).

[208]The existence of a legal power to claim the amount transferred is considered sufficient to support the annual exclusion under the U.S. statute. *See* Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). In addition, each contingent beneficiary is also able to be counted for the annual exclusion if such beneficiary has such a right. *See* Estate of Cristofani v. Commissioner, 97 T.C. 74 (1991).

[209]NZL EGD § 72 (exemption applies to all relatives as long as the amount of the gift is not excessive).

statute so that the gift tax base is not eroded by support payments. For example, support could be defined as transfers of in-kind consumption in addition to minimal amounts of currency.

Concomitant with the treatment under an estate or inheritance tax, gifts to spouses are generally exempt.[210] The same issues occur with respect to whether to allow exempt gifts to noncitizen spouses.[211]

Most nations exempt from gift duty transfers of property to the government[212] and to charities.[213] Also typically exempt are funds paid by an employer for employee retirement, pension, and benefit plans; bonuses paid to an employee if the bonus is in recognition of "special or faithful services rendered";[214] and death benefits payable to an employee's surviving spouse and/or dependents.[215] Premiums paid for life insurance on the life of the donor are commonly exempt from gift duty, subject to certain monetary limitations if the policy is for the benefit of a spouse and/or dependent children.[216]

[210]*See supra* sec. III(A).

[211]In the United States, there is no unlimited exemption for gifts to noncitizen spouses; *see* USA IRC § 2523(i) (gifts limited to $100,000 a year).

[212]*See, e.g.*, Inland Revenue Act, 1980, § 54(e) (LKA) (abolished 1993); Gift Tax Act, 1958, § 5(iv) (IND); Gift Duty Assessment Act, 1941–1973, § 14(d) (AUS) (abolished 1979).

[213]*See, e.g.*, NZL EGD § 73.

[214]Gift Duty Assessment Act, 1941–1973, § 14(b) (AUS) (abolished 1979).

[215]*See, e.g.*, NZL EGD § 75.

[216]Gift Duty Assessment Act, 1941–1973, § 14(g) (AUS) (abolished 1979) (premiums may not exceed $A 200 a year); Gift Tax Act, 1958, § 5(ix) (IND) (premiums may not exceed RS 10,000 in aggregate for each donee).

11

Social Security Taxation

David Williams

Will you still need me, will you still feed me, when I'm 64?

—*John Lennon and Paul McCartney*

I. Introduction

Social security taxes are a major revenue source and a critical element in fiscal policy.[1] Most, but not all,[2] states have social security taxes. Some states with mandatory contributions to the funding of social security schemes do not call those contributions "taxes." Nor do states always pay close attention to the interaction between their social security taxes or contributions and other

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[1]For further information on this subject, *see* Janet Stotsky, *Payroll Taxes and the Funding of Social Security Systems*, *in* Tax Policy Handbook 177 (Parthasarathi Shome ed., 1995).

Much useful literature is published by the International Social Security Association. *See infra* note 4. Other current summaries of national social security systems are available in the following publications: Coopers & Lybrand, 1995 International Tax Summaries (summarizing the position in most states) [hereinafter C&L 1995]; Organization for Economic Cooperation and Development, The Tax/Benefit Position of Production Workers, Annual Report Information Covering 1990–93 (1994)(containing details for each of the OECD member countries) [hereinafter OECD Tax/Benefit Report]; OECD, Revenue Statistics of OECD Member Countries 1965–93 (1994)(published annually) [hereinafter OECD Revenue Statistics]; K.C. Messere, Tax Policy in OECD Countries 167–84 (1993). For more detailed summaries of the position of most European countries, *see* 6 International Bureau for Fiscal Documentation, Guides to European Taxation, Taxation of Individuals in Europe (looseleaf) [hereinafter 6 IBFD European Taxation]. The European Commission has also published summaries of the systems operating in the European Union. Comparative Tables of Social Security Schemes (5th ed. 1990).

[2]Larger countries without any social security taxes include China, Australia (at federal level), Indonesia, and Thailand. *See* OECD Tax/Benefit Report, *supra* note 1, at 110 (regarding Australia). For a full comparison of coverage in 1990, *see* World Bank, Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth, tbls. A.1 to A.6 (1994).

taxes. Yet, most states incur social security expenditure. In some, such as those with economies in transition, social security expenditure and related social welfare costs can be the largest part of the fiscal obligations of the state. It is also accepted that the burden of social security expenditure is growing and will continue to grow during the foreseeable future.[3]

In Europe in particular, the law of social security has evolved together with labor relations law. Although the same enthusiasm for this approach is not present in the Americas and Asia, international agreements have been formulated to set minimum standards of entitlement to social security and to coordinate social security systems among states. These have been devised under the auspices of the International Labor Organization (ILO), an intergovernmental body, and the International Social Security Association (ISSA).[4] As a result, the terminology and concepts used in social security law have tended to be drawn by analogy with labor relations law rather than with tax law in Europe. Some effects of this Eurocentric approach are noted in this chapter.

The comparative history of social security taxes and contributions in different countries shows widely varying approaches. The developed countries that do not have a compulsory social security contribution or tax are in a small minority.[5] In contrast, in other countries, social security taxation is the most important single source of public revenues.[6] Countries with economies in transition gener-

[3]Detailed treatment of the problem of levels and trends in social security expenditure is beyond the scope of this chapter. The main problem is that of the growing world population of older people. The World Bank recently provided an updated analysis of the problem in Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth (1994). *See* World Bank, *supra* note 2. The key conclusion is that the number of people over 60, measured as a percentage of the total world population, will double between 1990 and 2030, and that this growth would be reflected in all parts of the world. For a critique of the report by authors from the International Labor Organization and the International Social Security Association, *see* Roger Beat & Warren McGillivray, *A Risky Strategy: Reflections on the World Bank Report "Averting the Old Age Crisis,"* 48 Int'l Social Security Rev. 5 (1995).

[4]The ILO, based in Geneva, is a specialized agency of the UN. ISSA is a nongovernmental body unofficially linked with the ILO, and also based in Geneva. The members of ISSA are representatives of individual social security schemes (national, industry-based, or specific). ISSA has a regular conference and publication program on contribution and benefit issues.

[5]Of the OECD member states, only Australia and New Zealand have no, or minimal, social security taxes. OECD Tax/Benefit Report, *supra* note 1, at 110, 186; *see* Messere, *supra* note 1, tbl. 8.1, at 183. Denmark also used to have minimal contributions, but in a reform taking effect between 1994 and 1997, it is introducing a "labor market contribution" payable by employees, employers, and the self-employed. 6 IBFD European Taxation, *supra* note 1, at 63; OECD Tax/Benefit Report, *supra* note 1, at 131. Korea also has no social security contributions, although it has a less common education tax. KOR BNTA, part XIV.

[6]OECD Revenue Statistics, *supra* note 1, shows that 45 percent of total French tax revenues come from social security contributions, 39 percent of total Dutch revenues, and 38 percent of total German revenues. *Id.* at 21–22. The definition of "public revenues" is that used in OECD Revenue Statistics. *See id.* at 28 *et seq.* This publication monitors both taxes and other contributions to schemes operated within the government sector. *Id.* at 10. For example, Finland (like most Nordic countries) has high compulsory contributions to a general scheme, but does not regard this as taxation, even though the contributions use tax laws for assessment purposes. 6 IBFD European Taxation, *supra* note 1, at 55.

ally have social security taxes. In some they are a major burden and, in those countries, social security is one of the most important fiscal problems of the state.[7] Many developing countries are also faced with problems of social security funding as their economies change and develop.[8]

Social security taxes should therefore, it is suggested, be part of the agenda for a review of the tax law of any state. The adoption and operation of any form of social security taxation should be undertaken as part of or parallel with the total tax structure of the state. It is for these reasons that this chapter analyzes the legal issues inherent in imposing social security taxes within a state's general tax system.

Whether a state has social security taxes or not, all but the least developed or least interventionist of states have social protection expenditure. The choice between direct and indirect funding of this expenditure must affect the fiscal pattern. This is a policy issue, but one with significant practical implications at both internal and international levels. A state that funds all or most of its social expenditure by levying taxes on employees, their employers, and the self-employed is committed to significant levels of income taxation. If the state intends also to collect a general income tax, it must consider both the interaction between the two taxes and their combined effect.[9] It must also consider that, while it can reach international agreements to offset double income taxation, agreements rarely do this for social security taxes. A result may be that a state that chooses to collect social security costs through high social security taxes rather than through income taxes may tax some export transactions more heavily than states that use higher income taxes offset by reliefs.

Conversely, a state that chooses to bear all or most of its social security costs from general revenue must also determine whether direct or indirect taxes will bear that burden. If the cost is transferred primarily to income tax,[10] the levels of tax become significantly higher than what would otherwise be required. Otherwise, general levels of state expenditure are forced down. If a state chooses indirect taxes, then it is likely to face problems in levying them.

[7]The subject was extensively reviewed recently in ISSA, Restructuring Social Security in Central and Eastern Europe (1994). *See also* George Kopits, *Social Security*, *in* Fiscal Policies in Economies in Transition 291 (Vito Tanzi ed., 1992).

[8]For an account of recent reforms in Argentina, Colombia, and Peru, *see* Monika Queisser, *Chile and Beyond: The Second-Generation Pension Reforms in Latin America*, 48 Int'l Social Security Rev. 23 (1995).

[9]The contrast in approaches in OECD states is sharp. In France and the Netherlands, lower-paid workers pay far more in social security contributions than in income tax. In Australia and New Zealand, there are no separate social security taxes, although a tax on fringe benefits is imposed on employers in addition to the income tax. For an annual survey of the position in each OECD member state, *see* the annual volumes of OECD, The Tax Benefit Position of Production Workers; *see also* note 1 *supra*.

[10]As in Australia, which adopted a fringe benefits tax that imposes an additional charge on employers who grant fringe benefits to their employees. New Zealand, which also has no direct contributions to social funding, adopted a similar tax. C&L 1995, *supra* note 1, at A-39 to A-40.

For example, a high level of value-added tax (VAT)[11] will impose a burden on all those whom the social expenditure seeks to benefit. The level of benefits, and consequently of contributions, may have to be raised to offset the burden of the indirect tax if the base of that tax is not to be affected.[12] If, instead, the form of the indirect tax is affected, then other problems about the efficacy of that tax arise.[13] Again, there may be international aspects to this if the resulting tax affects internal costs and export costs without affecting import costs.

Much of the above is a matter of general state and fiscal policy and concerns macroeconomics and public finance rather than law, and so is beyond the scope of this book. However, unless all tax, benefit, and contribution patterns are looked at together, many points made elsewhere in this book about forms of taxes may be modified in unintended ways. Specific examples of this issue are raised at the end of this chapter.

A. What Is Social Security?

To clarify the scope of this topic and chapter, the terms to be used in the discussion must be defined.[14] In addition, the limits imposed on the analysis in this chapter must also be set forth.

"Social security" is the commonly accepted global term[15] for public schemes (provided or regulated by the state)[16] for the social and economic protection of individuals and families. Social security is normally classified under five headings:

- old-age, invalidity, and survivors' benefits;
- benefits for sickness and maternity;

[11]This is one factor in the high VAT rate in Denmark, and the reason why Denmark attempted to adopt its employment levy and has since adopted its labor market contribution scheme. *See infra* note 22.

[12]This happened in New Zealand upon the introduction of the broad Goods and Services Tax. *See supra* ch. 6. New Zealand, however, does not impose social security contributions.

[13]The issue of socially sensitive exemptions from value-added tax is discussed in ch. 6, *supra*, where it is argued that such exemptions should be minimal.

[14]*See also* sec. II(A).

[15]This is true in the English language. Terminology in other European languages is similar and poses few terminological problems.

[16]Analysts have categorized the approaches that states may take in providing or encouraging provision of benefits for individuals with a social effect. The six accepted, basic kinds of approach are (1) social insurance; (2) employer mandates, or compulsory provision of employee welfare benefits by employers; (3) individual mandates, or compulsion on individuals to provide for their own welfare benefits; (4) tax-supported voluntary arrangements; (5) social assistance, or means-tested welfare payments financed from general funds; and (6) universal schemes, with entitlement for all citizens or residents funded from general funds. This chapter focuses on schemes that fall in category (1), with less attention to categories (2) and (3). Category (4) is relevant in the context of the interaction between tax and social security. For a recent critique of these approaches, *see* Lawrence H. Thompson, *The Advantages and Disadvantages of Different Social Welfare Strategies*, Int'l Social Security Rev. 59 (1995).

- occupational or work-related risks;
- unemployment protection; and
- family assistance.[17]

States with social security schemes may not provide all these benefits. For example, there may be no unemployment benefit scheme because the state provides no support for the unemployed.[18] The state may instead provide a means-tested benefit funded from general taxes for those without income or savings. There may also be separate organizations and separate contributions to different benefits. For instance, the state may provide family assistance for all children, financed from general taxes, while having separate contributory pension and work-related benefits.

If funding is provided on a form modeled on commercial insurance, it is often termed "social insurance."[19] It is distinguished from "social assistance," whose chief activity is the provision of minimum incomes or material help to the poor, often on a means-tested basis.[20] In some countries, health care and support for families or children are provided through "universal benefits" given to all regardless of contributions or ability to pay.[21] Some are financed by contributions, and others by general tax revenues. If such schemes do not involve contributions, they are omitted from further discussion in this chapter. This chapter is concerned only with forms of social security met by specific funding from any source, but not those funded through general tax revenues. Most states with social security schemes have separate social security funds to meet this form of expend-

[17]This framework has long been the basis for discussion and action by the ILO, the international body with prime responsibility for this area of activity. *See also* Messere, *supra* note 1, at 170 (commenting that contributions for other benefits in the OECD states "are of negligible revenue importance").

[18]That is, there is no special compensation for unemployed individuals, as opposed to welfare payments for those without income.

[19]*See supra* note 16, in which this is category (1). Social insurance has been defined as consisting of schemes with the following attributes: compulsory membership extending beyond government employees; compulsory contributions payable by members (or their employers); government regulation or support; prescribed benefit entitlements; benefit entitlement deriving from contributions, but not directly related to them; and separate scheme accounting and financial planning. *See* Robert J. Myers, Social Security 877 (4th ed. 1993)(setting forth the definition developed by the Committee of Social Insurance Terminology of the American Risk and Insurance Association).

[20]*See supra* note 16, categories (5) and (6).

[21]An example is the U.K. national health service, which is available to all residents without contribution or charge. It is funded largely from general taxes, but also from a (largely hidden) levy on social security contributions. The hidden levy is authorized by the Social Security Administration Act, 1992, ch. 5, § 162. Known officially as the national health service allocation, the levy is between 10 percent and 15 percent of total contributions, but is not separately identified in any way to contributors. Free national health services were established by the National Health Service Act, 1946, ch. 81, § 1.

iture.[22] Specific social security taxes or contributions are widely used to finance such funds.

This chapter is not about social security systems as such. There is no discussion of general policy issues, such as the desirability of public provision of social support, or of the kinds of social security benefits that might be funded through specific social security taxes. There is no discussion of the detail of social security benefits.[23] Other topics excluded from this account are personally funded benefits, such as retirement benefits, the general issue of pensions, the peculiar legal problems involved with compulsory but largely privatized schemes that are found in countries such as Chile or Peru, and the voluntary provision of pensions.

The focus, therefore, is only on compulsory or state-mandated systems, which, in some countries, are also state run.[24] In other countries, the administration of the system is in the hands of separate organizations or agencies.[25] The administrative structure of social security is not addressed in this chapter, except insofar as it relates to the use of the state tax authorities for the collection of contributions.

B. Are Social Security Payments Taxes?

When is a payment to a social security fund a tax? The answer to this question in any particular state depends on its constitution and laws. As a general conceptual matter, it also depends on how government and others view the payments. The assumption in this chapter is that a contribution to a social security fund is a tax if there is a requirement to make payments either to state funds or to state-regulated funds from which there is an obligation to pay social

[22]For example, Denmark has significant social security benefits financed from general taxes, although it has only recently started introducing specific contributions. The specific contributions are imposed by the Labor Market Fund Law. Lovbekendtgorelse nr. 837 af 28.9.1994 am arbejdsmarkedsfonds. The rate was 6 percent in 1995 and will be raised to 8 percent by 1998. *See also* Danish Labor Market Supplementary Pension (ATP), Annual Report (1995).

[23]ISSA produces a significant amount of literature on these issues and also publishes a regular international bibliography. *See* World Bibliography of Social Security (semiannual); Catalogue of ISSA Publications (semiannual).

[24]This is the method throughout Central and Eastern Europe. *See* Restructuring Social Security in Central and Eastern Europe, *supra* note 7; Kopits, *supra* note 7.

[25]This approach is used in many Western European countries. In the United States, the Social Security Administration was recently made an independent agency in the executive branch of the Government. Social Security Independence and Program Improvements Act, Pub. L. No. 103-296, 103d Cong., 2d Sess., 108 Stat. 1464 (1994). This is one of many institutional reforms that have taken place to the structure of social security schemes in recent years. Institutional changes are summarized in the ISSA newsletter, Trends in Social Security (published quarterly).

security benefits.[26] In short, the payment must be mandatory and must be state regulated. If the potential payer can choose whether to make the payment, then it is not a tax.[27] In some countries, the system of social security payments is mixed, with some payments being compulsory and others voluntary. A complete account of social security must deal with all forms of payment. However, the system is, for present purposes, a tax system only if a substantial part of those payments are compulsory.[28]

The working definition does not resolve a question of characterization: are contributions, although mandatory, *really* taxes or are they actually insurance premiums? Some argue that the payments constitute, in essence, an insurance premium or a contribution. The payments will, or may, be returned to the payer as benefits. They are therefore, viewed from that standpoint, not taxes.[29] Unless the payments have the individualized market character of premiums related to the risk presented by each person insuring (adjusted, for example, to take account of the illnesses an individual suffers or whether the individual smokes or of the risks of a particular employer's activities), this argument is not conclusive.[30] It may affect the presentation of the system to those required to pay, but it does not affect the underlying requirements of the law in imposing the contributions. If contributions are risk related and are determined by actuaries rather than by law, then at least some features of the scheme are not truly tax features.[31] It must be recognized that contributions in

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[26]This is offered as a working definition. It reflects the OECD working definition of a tax in its *Revenue Statistics*, published annually. This defines taxes as compulsory general payments for public purposes and includes social security contributions. For further discussion, *see* the introduction to each year's volume. This is not offered as a formal definition because the wide variety of arrangements that have been adopted make it almost impossible to generalize. For example, in Peru, employees are required to insure through either the state scheme or a private scheme. Insurance is mandatory, but public insurance is not. Therefore, the individual can choose between the social insurance scheme and private schemes.

[27]For example, social security coverage of the self-employed is sometimes voluntary (e.g., Germany). 6 IBFD European Taxation, *supra* note 1, at 41.

[28]For example, a state may impose contributions on most citizens, but may allow those not required to pay to be voluntary contributors. This happens in the United Kingdom, where "Class 3" contributions are authorized by the Social Security (Contributions and Benefits) Act, 1992, ch. 4, § 13. The Irish scheme contains a similar provision. Social Welfare Act, 1993, § 21.

[29]This approach is often adopted in France, where the institutions running social security schemes are much nearer the market model than in neighboring countries, such as the United Kingdom and Ireland, which have uniform state-run systems.

[30]Generalization again is difficult because some states have hybrid schemes. Compulsory insurance (e.g., that required of employers who are liable to employees for accidents at work) is widespread. It may occur through a state scheme or by obliging companies to take out private insurance, which may or may not be regulated. Premiums may be individual to companies, generalized across industries, or spread throughout all similar workers or across the entire working community.

[31]This is true of some features of the French system where contributions are often closely related to risk because of the many different funds within the French compulsory system.

some states imposing national standard social contributions are nonetheless regarded by all concerned as not part of taxation. It must also be recognized that the characterization is a political and cultural matter to which, in the abstract, there is no "correct" answer.

For some purposes, a compulsory payment may not be considered a tax if the payment creates an entitlement to a benefit.[32] It may be relevant in this regard that social security systems generally do not involve an entitlement to benefits, because the legislature has the power to change the formulas under which benefits are determined, even with respect to benefits that relate to contributions that have already been made. Some argue that the feature that benefits can be set independently of contributions distinguishes tax-style systems.

A second argument against categorizing compulsory contributions as taxes is the identity of the fund-holding or administering body. In some states, the fund is held by the state itself as part of the general tax and budget exercise.[33] In others, it is held by the state, but in separate funds.[34] In yet others, it is held by extrabudgetary bodies that are state entities.[35] Finally, in other states, the funds are run by separate individual funds under general state control.[36] For present purposes, the identity of these bodies is not relevant if payments to them are compulsory, provided only that they are state, or state-regulated, bodies. Nonetheless, the primary focus of the chapter is on state social security funds rather than on state-regulated private bodies.

Regardless of whether social security contributions are treated as taxes under the constitution and laws of a particular country, they are justifiably considered as taxes for purposes of this book because the contributions are imposed by legislation that involves the same issues as other tax legislation and that interacts with other tax laws, particularly the individual income tax law. Therefore, the approach to drafting such laws and other tax laws should, to the extent the laws fulfill parallel functions, be a common or parallel one.

The definition of when a contribution is, for present purposes, a tax, also does not resolve the question of terminology. Two contrasting pressures apply in practice. In some states, social security taxes are neither called "taxes" nor

[32] *See* Treas. Reg. § 1.901-1 (as amended in 1987)(USA).

[33] For example, the limited provisions in Australia and New Zealand.

[34] As in the United Kingdom, where the National Insurance Fund was created under the authority of the Social Security Administration Act, 1992, ch. 5, § 161.

[35] As in Russia. Restructuring Social Security in Central and Eastern Europe, *supra* note 7, at 242.

[36] As in France, where control is exercised through the Commission des comptes de la sécurité sociale. The French system pools contributions to fund current beneficiaries, but others, such as the Singapore system, hold individual funds for individual contributors. Under the Singapore arrangements, a contributor may only benefit to the extent of contributions made by or for the contributor. This leads the Singapore authorities to argue that their system is a savings scheme, not a social security scheme. *See Letters*, The Economist, May 11, 1996, at 10.

treated as such in the legislation. Terms such as "contributions," "insurance contributions," or "premiums" are used instead. The standard general term in English is "contribution," the term used in this chapter.[37] In contrast, other states avoid the use of "social security" and use tax terms, such as "payroll tax," that do not refer to the purpose of the tax.[38]

C. Is the Legislation for Contributions Tax Legislation?

Responsibility for legislation on social security contributions varies between states, and so does its form. Sometimes, the legislation is presented as part of the general social security legislation, so that the contributions and the benefits are presented as an entity.[39] Alternatively, the legislation may be treated as social security legislation, but kept apart from the details of benefits payable.[40] In contrast, the legislation imposing contributions may be treated as tax legislation and kept entirely separate from benefit legislation.[41] Is that important? The practical answer is that the matter is unimportant unless there are either special constitutional or legislative procedural requirements for taxation. If such requirements exist, it may be possible to avoid them by presenting contributions law as part of general social security law. In other states, social security contributions may be given the form of taxes so as to take advantage of broad taxation powers under the constitution or general tax legislation.[42]

[37]This is the term usually used by the ILO and ISSA. It is used in the United Kingdom, Ireland, and Canada. However, the United States refers to social security or payroll taxes (for constitutional reasons). The French equivalent term is *cotisation*. It may be noted that the U.K. income tax (one of the world's first) used to refer to the income tax as a "contribution"! In the United Kingdom, the term "contributions under the Social Security Acts," is sometimes used; *see* Social Security Contributions and Benefits Act, 1992, ch. 4, § 1, but the term "national insurance contributions" is popularly used by government departments, even though this ceased to be the technical term in 1973.

[38]For example, the payroll tax in the United States. However, the formal name in the U.S. legislation is "contribution," and the schemes are often referred to by the initials of the enabling legislation as FICA (Federal Income Contributions Act) and SECA (Self-Employed Contributions Act). The terminology used in the United States was adopted in 1935 specifically to avoid possible historical constitutional problems. This terminology raises a further issue in tax theory, namely, the identification of these taxes as direct or indirect. One relevance of this classification is whether the taxes are within the scope of double tax conventions. Article 2 of the OECD Model Tax Convention on Income and on Capital of 1992, *reprinted in* Philip Baker, Double Taxation Conventions and International Tax Law (2d ed. 1994), states that "payroll taxes" are within the scope of the model, but paragraph 3 of the commentary on that article makes it clear that it does not extend to social security taxes if there is a direct link between the contributions and the individual advantages received from the contributions. Alternatively, if they are indirect taxes, they may be within the scope of the General Agreement on Tariffs and Trade. *See* Richard A. Musgrave, Fiscal Systems 174 (1969)(noting that many considered payroll taxes to be indirect, in his view wrongly).

[39]As in the United Kingdom. *See* Social Security (Contributions and Benefits) Act, 1992, ch. 4.

[40]As in the Netherlands. *See* Gerrit te Spenke, Taxation in the Netherlands ch. 6 (1995).

[41]As in the United States. *See* Steward Machine Co. v. Davis, 301 U.S. 548 (1937).

[42]This approach has been considered by a number of states of the former Soviet Union.

A final constitutional issue is that of the level of imposition within federal states. In some states, elements of social provision take place at the local rather than at the national level, thus preventing a state scheme from operating.[43] This may also mean that social security taxation is operated at a different level of government from the income tax.[44]

D. What Are the Forms of Social Security Tax?

The inconsistencies of national practices about social security funding are reflected in the varying forms of contribution adopted. States have a series of choices in deciding the form that contributions take.[45] These choices are influenced by two conflicting pressures, the fiscal context of the contributions and the linkage between contributions and benefits.

A key decision about the contribution structure of a scheme is whether there is to be one global contribution to all forms of funded social security[46] or separate contributions for each separate form of social protection.[47] This issue is usually decided by the institutional structure of the social security system. If different funds or institutions are responsible for the different elements of social security, there is strong pressure to provide different contributions to each institution.[48] There are also policy arguments for separating, at least in name, the contributions to different funds so that different policies may be followed about whether and how much of the contribution is paid by the employer and how much by the employee.[49]

This raises a further issue. Is the contribution treated as a series of separate contributions[50] or as a single payment to be made by the contributor but consisting of separate amounts for different funds?[51] Having separate amounts of

[43]This happens in Canada and Switzerland. *See* International Tax Program, Harvard Law School, World Tax Series: Taxation in Switzerland 94 (1976).

[44]In Canada, both income tax and social security contributions are levied at both federal and provincial levels.

[45]For two recent general policy discussions, *see* Kopits, *supra* note 7; Messere, *supra* note 1, at 167–84.

[46]As in the United Kingdom. Although as noted in note 16, *supra*, a part is transferred to help fund health costs.

[47]Or, alternatively, for groups of benefits. Multiple schemes are the most common form of system adopted in developed countries with full social security systems.

[48]This is reflected in the way contributions are set in many European states, for example, in France, Germany, and Russia.

[49]This can result in quite complicated patterns of contribution. For example, in Austria, in 1995, there are five elements in an employer's contribution, four of which are also elements in an employee's contribution. Of these, two are shared equally between employer and employee; one is heavier on the employer; one is heavier on the employee; and one (as noted) is borne only by the employer. In addition, employers make two other separate contributions to social funds. C&L 1995, *supra* note 1, at A-55.

[50]In France, the contributions are to separate funds with individual powers to set contributions; no mechanism exists to unite the contributions.

[51]As in the Netherlands. *See supra* note 40.

contribution for each separate form of benefit reflects the view that there should be separate contributions to each fund and also separate accounting and actuarial analysis.[52] The rationale is that the independence of the separate funds is recognized by separation of the contribution payments. This is, it is suggested, neither necessary nor an efficient use of contributors' money.[53] The collection of a composite contribution is usually more efficient, and therefore less expensive, than multiple collections. The authority acting as agent in collecting the contributions can, of course, arrange subsequent distribution of contributions to those organizing the individual funds. In this discussion, only one contribution is assumed to be collected from any contributor for any contribution period, regardless of how the contribution is calculated or shared out after collection.

Second, contributions are collected in a variety of ways. They may be collected from the groups covered by the schemes only[54] or from taxpayers generally.[55] They may take any form adopted in general taxation or in insurance and pension practice. The cost of social protection for employees tends to be imposed on employers generally and sometimes on their employees. However, there is no consistent pattern of the share of the contribution burden between the employer and the individual. The payment is usually a payroll tax on the employer or a form of income tax imposed on the individual or the employer (or both). By their nature, these forms of tax are income related. Sometimes contributions are risk related at a generalized level of risk. The ultimate form of tax on this basis is a poll tax. All those within the scheme pay the same contribution in money terms and so share the risks.[56] The self-employed may also be asked to make an income-related contribution or a flat-rate contribution (or both); this may be set to imitate the contributions of employers and employees.

If the employee or employer's contribution is income related rather than risk related, it may take the form of a second income tax. This could be—and

[52]This is seen, for example, in France and Russia. In Russia, each area of funding is independent of the others.

[53]Against this argument, the point must be made that settled, but separate, systems, such as those in Germany, can operate most efficiently. In part, this is because the necessity of the social security funds is widely accepted by those paying contributions, so that there is a high level of voluntary compliance and a low level of disputes. These factors may more than compensate for the absence of other forms of efficiency.

[54]This is the most common pattern. If the contributions are not covered by the groups affected, there is an argument that they are not "proper" social security contributions, but are general taxes. *See supra* note 38 (noting the working definition in the OECD Model Tax Convention).

[55]As in the Netherlands. *See supra* note 40.

[56]Flat-rate contributions used to be common, but have tended to be replaced by income-related contributions. This chapter therefore assumes that contributions are income related rather than flat rate.

sometimes is—collected with the main income tax.[57] It can be set perhaps as an extra rate of income tax.[58]

It is frequently assumed that contribution liability arises in respect of the earnings of the contributor. Although the definition of earnings is relatively straightforward for most employees, it is less obvious for the self-employed (or for those who are both employed and self-employed).[59]

Whether individuals should pay contributions on unearned income is a complex question of policy. If the social security system is designed essentially as an income replacement system for earners, then principle suggests that contribution liability should be based only on earnings. The extreme case is that of the individual who has no earned income, but has a significant source of investment income. Such an individual will in most states fail to qualify for social security benefits on the ground that he or she is not a member of the social security scheme. There is no risk of loss of income through unemployment, sickness, disability, or retirement, and, therefore, no need to ensure against these risks. Use of health facilities can be made subject to payment. Social security is therefore largely irrelevant to the limited number of individuals in this group, and principle suggests that they should be excluded from both benefits and contribution liability. Similarly, the unearned income of those within the system can be ignored for both benefit and contribution purposes, which simplifies administration. However, it demands a clear distinction between forms of income inside and outside the scope of contribution liability. There is also a contrary argument based on social solidarity and the use of income taxes to redistribute wealth between citizens. This argument leads some states to use nonearned income that is liable to income tax as a base for charge to social security contributions as well.[60]

In the discussion that follows, it is assumed that only earned income is used for contribution liability. Some problems of definition of earned income are discussed in connection with the contribution liability of the self-employed. The discussion of the liability of employees ignores any income other than employment income.

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[57]This is common practice in most Western European states. For surveys of the practices in Western Europe, *see* the works cited in note 1 *supra*.

[58]The extreme case is perhaps the Netherlands, where the main rate of income tax on most taxpayers is the social security tax, and the "proper" income tax is at a much lower rate on those taxpayers, reaching higher rates only on the taxpayers earning the highest incomes. *See supra* note 40. The rates in 1994 were 31.075 percent social security tax and 7.05 percent income tax on the first f. 43,267, with no social security tax but a 50 percent marginal income tax rate applying to income immediately above that level. C&L 1995, *supra* note 1, at N-3.

[59]*See infra* secs. II(A), III.

[60]In the Netherlands, the social security tax is levied on most forms of income, including investment income. *See supra* note 40. In France, a special levy was placed on several forms of investment income and capital gains to provide extra revenues to support social security funds running into deficit. The Solidarity Contribution is imposed at 0.1 percent of turnover of companies whose turnover exceeds F 3 million. C&L 1995, *supra* note 1, at F-32.

While other forms of social tax are possible, such as the social equivalent of a VAT or a sales tax[61] or a levy on company profits,[62] these are not usual. The link between such a tax and the benefits it funds is far from transparent, except to the extent that the name of the tax clarifies the link. With these forms of tax, there is no clear relationship between those paying the tax and those benefiting from it, except that both are within the tax and social security jurisdictions of the state. There is little reason, save political expediency, to identify a general tax with social security expenditure. In addition, it is doubtful that the link could be maintained in the longer term. For example, a link between a sales tax and the cost of state health services may lead to inappropriate changes of tax rate or inappropriate levels of funding of the health service. While budget pressures may suggest use of these forms of social taxes in the short term, no special design or drafting issues arise because of the "social" labeling of the tax. Therefore, they are not discussed further in this chapter.

E. Links Between Contributions and Benefits

There is an inevitable linkage in any social security scheme between contributions to the scheme and benefits paid from the scheme. If contributions to the scheme and the income that the scheme itself generates do not match the total level of benefits that must be paid from the scheme, then the scheme will fail. Either further forms of funding must be found or benefit levels must be reduced. It is impossible, except in the very short term, to have a viable social security scheme if the benefits and contributions are decided independently of each other. In consequence, the level of funding of a scheme must be decided by primary reference either to the intended levels of contribution or to the intended levels of benefit. The method selected will influence the structure of the fund. The existence of the fund does not of itself determine how the contributions of any one contributor relate to the benefits to be received by that contributor unless the fund has only that contributor as a member.

Links between contributions and benefits can be of two kinds, reflecting the differences between funded and unfunded schemes. A funded scheme is a scheme in which the contributions paid in are used to create a fund from which benefits will, in due course, be drawn. If the fund has numerous contrib-

[61]A "social VAT"—in effect an extra levy on VAT—has been discussed recently in France. However, a compulsory Danish employment levy enacted in 1987 was ruled to be in breach of EU law by the European Court of Justice. Case C-234/91, Commission v. Denmark (Dec. 1, 1993), *summarized in* Proceedings of the Court of Justice and the Court of First Instance of the European Communities, No. 34/93, at 8 (Nov. 29–Dec. 3, 1993). The tax was essentially on the same basis as a VAT but did not comply with the general prohibition on EU states against introducing other forms of turnover tax. This effectively stops the adoption of social taxes in this form in the European Union.

[62]As in Brazil, where companies have to pay a 10 percent levy (23 percent for financial companies) to the solidarity fund. C&L 1995, *supra* note 1, at B-56.

utors, the level of contributions required by the fund is based on actuarial advice about the probable pattern of contributions, fund income, and benefits in the predictable future.

In funded schemes, the contributions paid in by an individual are saved to fund that individual's pension, on either an actual or an actuarial basis. In either case, the relationship between the contributor's contributions and benefit entitlement is provided in the structure of the scheme. Benefit entitlement, therefore, is based on the total actual contributions of or for the contributor, or the assumed total of contributions. The assumption of total contributions is often decided by reference to the length of service of the contributor in employments covered by the scheme. The actuarial basis of a fund will assume full pension entitlement only for a contributor who has contributed on all earnings throughout a set maximum period working for the employer, such as 30 or 40 years.[63] Those who contribute for less than that period will not receive a full pension.

An unfunded scheme does not retain contributions to meet future obligations to pay benefits to those making the contributions. Instead, it is run on the basis that current contributions meet current benefit expenditure.[64] This is subject perhaps to the maintenance of a buffer or reserve to ensure a smooth flow of both contributions and benefit payments. In an unfunded scheme, there is no economic link between an individual's contributions and the benefit entitlement of that individual. A person's pension contributions this year fund this year's pensioners. This person's own pension will be funded, it is to be hoped, by those contributing during the person's retirement.

Funded schemes therefore need links between the contributions and benefit entitlements of individuals, while unfunded schemes do not necessarily need such links. There are, however, good reasons to establish links within unfunded schemes as well. A formal link between benefit entitlement and contribution ensures that only those who have contributed can benefit from the

[63]States sometimes choose shorter periods than this or have no periods at all. For example, until 1994, the Finnish system had no qualifying period of residence for Finnish citizens. Since 1994, the period is five years after age 16. Further, the period of residence now affects the level of benefit, with a citizen receiving one-fortieth of the total pension in respect of each year of residence. Previously, there was no such requirement. *See Finland: Changes in Benefits*, Trends in Social Security (ISSA), Nov. 1995, No. 9, at 10 (referring to the Finnish National Pensions Act, 1993). Similar moves have also taken place under the Italian scheme. The French scheme increased the period for a full pension entitlement from 150 quarters to 160 quarters (40 years) on an incremental basis. *See France: Measures for Safeguarding Social Protection*, Trends in Social Security (ISSA), Nov. 1995, No. 9, at 12 (referring to decree of Aug. 27, 1993).

[64]This is the form of state scheme most commonly found in Western European countries, as well as in economies in transition. For a comparative survey, *see* Emmanuel Reynaud, *Financing Retirement Pensions: Pay-As-You-Go and Funded Systems in the European Union*, 48 Int'l Social Security Rev. 41 (1995).

fund. It is both a justification to contributors of why they are expected to contribute and an inducement to voluntary compliance with the obligations of contribution. It also reduces the effective cost to the fund of those who avoid or evade contributions.

The link between contributions and benefit entitlements may be either direct or indirect. A direct link requires a contributor to have made a defined level of contributions before receiving benefits.[65] That requirement may be small in the case, for example, of entitlement to benefit for industrial injury.[66] For long-term benefits, such as retirement pensions or survivors' benefits, the requirement may be for payment of contributions at a set level in each year of the contributor's working life (or until death before retirement). Assuming that contributions are related to earnings, the total of contributions may affect not only entitlement to any benefit, but also the level of benefit. A direct link imposes administrative requirements for an accurate record of the contributions of every individual who may have benefit entitlement. It also requires that the contribution record be readily available for the determination of any claim to benefit. This requirement may create problems if a complex contribution condition is imposed in respect of short-term benefits, such as benefits during sickness or unemployment.

A scheme may also use an indirect link, of which there are two effective forms. The first is the period during which the contributor is employed in employment subject to contributions.[67] In effect, this link measures the total time during which the contributor has contributed, but uses the contributor's employment record to decide this rather than the contribution record. The other form of link is by reference to the contributor's residency status.[68] To comply with entitlement under this form of link, the contributor is required to show that he or she resides in the territory covered by the scheme for a required period or periods. This basis can work if the territory is covered by only one scheme for the contributor. It also assumes that residents pay their contributions or taxes. A direct link between contributions and benefit entitlements may be more effective than the indirect alternatives in ensuring that contributions are paid.

[65]This approach is used in the United Kingdom and Ireland. The U.K. contribution conditions are set out in the Social Security (Contributions and Benefits) Act, 1992, ch. 4, sched. 3.

[66]A single payment may be enough to ensure coverage from the beginning of employment. Many states sidestep even this minimal problem by imposing the requirement to contribute on the employer alone.

[67]The French scheme depends on a wide range of individual schemes. The linkage is achieved in individual schemes by reference to periods of insurance of individuals, which is directly related to their having employment that is insured through the appropriate fund. *See supra* note 63 regarding the recent change in the linkage rules.

[68]The approach adopted, for example, in Denmark and Finland. *See id.*

II. Issues in Social Security Taxation for Employees

A. General Terms

For the reasons discussed previously, the terminology used in this chapter follows that normally used by social security lawyers.[69] The terms set out in this section are those used in the chapter. Most require definition, and these definitions are discussed in the following paragraphs.

Contributions: payments of social security tax, whether made directly by potential beneficiaries or by others. Contributions are assumed throughout to be compulsory. Any contributions that are not compulsory are termed "voluntary contributions." In this part of the chapter, "tax" therefore refers only to general taxation.

Contributor. A physical or legal person making or required to make a contribution is a "contributor," rather than a "taxpayer" or "insured person."

Employee. An individual working for another person is an "employee," and the nature of the work that the "employee" undertakes is "employment." Employees are sometimes also termed "workers," but that term is ambiguous because it may include workers who are not employees. The alternative phrase sometimes used for employment (particularly in civil law countries) is that of "dependent personal services," but this has only limited use in English. It contrasts with "independent personal services" or the services supplied by an "independent worker" or "self-employed person."

Employer. The person employing the employee is the "employer."

Self-employed. A person working independently, or engaged in independent economic activities of any kind (other than those of managing investments), is referred to by the usual English term of "self-employed person."

Unemployed. An individual who is neither an employee nor self-employed is said to be "unemployed." "Unemployed" is used to describe those not engaged in employment or self-employment. If the individual, because of independent resources, dependency, marriage, or for any other reason, is not seeking employment, it may be better to term the person "nonemployed."

Working age. Employees and the self-employed are of "working age" if they are over the age at which the state requires everyone to attend school on a compulsory basis and under the age at which an old-age pension becomes payable. States normally have general rules deciding the school-leaving age and the age at which the old-age pension becomes payable. It is normal to expect employees and the self-employed to pay contributions throughout the period when they are of working age, except while unemployed. Contributions might not be required below or above that age.

[69]There is no standard vocabulary. However, the U.S. Department of Social Security has published glossaries of terms in its *Handbook of Social Security Around the World* (annual).

Old-age pensioner. An individual over the retirement age (or pensionable age, as it is sometimes called) is normally called an "old-age pensioner" or, simply, a "pensioner."

Contribution period. Contribution liability arises with respect to defined periods, as does income tax liability. The standard income tax approach defines liability by reference to a fiscal year (often a calendar year), but it may also do so by reference to the calendar month or to the amount of a payment. Contribution liability may also arise with reference to a year. The analogy to labor relations law may mean that the period to which the contribution is related is the primary period for payment at work, usually a week or a month. The question of the length of this period is addressed below.[70] For ease of discussion, the term "earnings period" describes the period used to decide the amount of a contribution. An earnings period can be as short as a day or as long as a year depending on the administrative policy of the scheme involved.

B. What Is Employment?

The distinction between economic activities that are characterized as employment and those that are considered self-employment is fundamental to the laws that impose liability to contribute to a social security system and to the laws providing for benefits from a system. The distinction is found in the laws of countries of all legal traditions save those where the whole economy is regulated and the roles of individual workers are controlled.[71] It is widely used for social security purposes, although some states deal, instead, with categories of economic activity.[72]

The distinction is also important for several reasons other than social security. For example, it is often important in defining the liability of an individual to the income tax.[73] It is important for VAT purposes because an employee is not a taxable person for VAT.[74] The rights of an individual under employment law or labor relations law depend on the individual establishing that he or she is an employee. Civil contract and liability rights, and rights under insurance legislation, also depend on the same distinction.

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[70]*See infra* sec. II(L).

[71]This used to be the case in countries such as China and the Soviet Union.

[72]For example, those engaged in agriculture and fisheries are given separate treatment in Iceland. C&L 1995, *supra* note 1, at I-4; *see also* for Norway, 6 IBFD European Taxation, *supra* note 1, at Norway 43. In Belgium and Luxembourg, manual workers are treated separately from office workers. 6 IBFD European Taxation, *supra*, at Belgium 46–47; C&L 1995, *supra*, at B-27, L-44. In both cases, the rates for industrial workers payable by employers are higher than those for office workers. Spain has different minimum and maximum levels of earnings within which contributions have to be paid for different activities. 6 IBFD European Taxation, *supra*, at Spain 65–66.

[73]*See* vol. 2, ch. 14.

[74]*See supra* ch. 6, sec. III(E).

Although the concept of employment or dependent personal services is most important, it has generally proved difficult to define. For some groups, the definition is relatively easy. For example, those working in government service can usually be regarded without difficulty as state employees if they are under the authority of the state. This includes those working for the armed forces of the state and the state's diplomatic service. This is so for other large employers. The employees work on standard terms and within a clear structure that sets out the duties of each employee and the wages or other benefits received by the employee.

There are other groups of workers for whom the position is less clear. Are professional workers regarded as employees, or are they regarded as members of a profession and treated as self-employed whether actually employed or not? Should those working for several employers be regarded as engaged in part-time employment for a series of employers or as self-employed (or both)?

The definitions of employer, employee, and employment are all linked. The key to these definitions is the employment relationship between the employer and the employee and the other terms are best defined by reference to it. It is also important to ensure that the definition of these terms is the same for both contributions to the social security scheme and entitlements from it, so that the link between contributions and benefits is clear. In this way, a state may establish a more formal link, such as making benefit entitlement dependent on the payment of contributions.

The social security meaning of employment has traditionally been linked to the meaning of employment that is accepted as a matter of labor relations law (often called "employment law").[75] This means that an individual who is regarded as an employee for general labor relations purposes is also regarded as an employee for social security purposes. This definition will often also be used for other legal purposes. For example, it is used for civil liabilities of the employer to the employee (and the reverse), or of either to third parties.

As a point of both practice and principle, the definition of employment should be the same for both liability to pay contributions and entitlement to receive benefits. Any differences weaken the link between contributions paid and benefits received and may also increase the administrative burden of running the system. It is particularly important that the system ensure that a contributor cannot avoid contributions and then claim benefits. For example, the contributions due from or for employees are usually higher than those for the self-employed. If an individual can claim to be self-employed while contribut-

[75]The laws of different nations view the key terminology as linked in different ways. The U.K. definition of "employed earner" is "a person who is gainfully employed . . . either under a contract of service, or in an office. . . ." Social Security (Contributions and Benefits) Act, 1992, ch. 4, § 2(1)(a). Similarly, in French law, an employee is defined as "a person working for another person called the employer who supervises and controls his or her activity in exchange for which the employee receives a salary." Code de sécurité social art. L 311.2. Both definitions rely on undefined references to general labor relations law.

ing, but then claim to be an employee to obtain higher benefits, then the system is open to abuse.

There is also a clear linkage between the definition of employment for social security purposes and the use of the same term to define the liability to other taxes. For example, income tax law also requires a definition of the status of an employee and of income from employment.[76] A person can register for VAT, or be required to register, only if the person is, in the terminology used here, self-employed.[77]

There is much to be said for establishing a common approach to definition across all these laws and taxes, although the different laws will require specific provisions to deal with problems specific to each tax. A common definition ensures that those who claim rights as an employee must also be shown to have paid tax and contributions as an employee. This does much to stop abuse of the system.

If a common definition is used, clear references should be introduced between the laws ensuring that key definitions are applied uniformly. This simplifies the application of the law, but it does not by itself ensure uniform resolution of disputes. Even with a common definition, it must be decided who is to handle a disputed question about the status of an individual. In practice, different authorities must decide for their own purposes, and their conclusions may not be consistent. While there are obvious advantages in defining and applying laws consistently, it may not be easy to accomplish. For example, the labor relations courts or tribunals decide disputes for labor relations purposes. If a labor relations tribunal is not involved, the parties to a relationship decide by mutual agreement whether they treat a relationship as employment or not. For income tax and VAT purposes, the tax authorities may be called upon to decide how an individual is to be taxed, subject to appeal to tax courts or tribunals. This may result in divergence, particularly because tax tribunals and labor relations tribunals are likely to be involved at different stages of an employment. It is difficult to ensure consistency among the different courts and tribunals without affecting their jurisdictions or independence. A practical alternative may be to secure agreement between administrators. For example, the tax and social security authorities may agree that they will normally respect each other's rulings in individual cases.[78] If there is a common definition, the superior courts can also ensure consistency and, at this level, bring together the approaches of lower tribunals.

This general approach to the definition of employment raises some difficult issues for social security. Problems particular to social security contribu-

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[76]*See* vol. 2, ch. 14.

[77]The terminology used for VAT purposes is different, and the reference is to a person engaged in independent economic activities. *See supra* ch. 6, sec. IV(B).

[78]This approach has been adopted in the United Kingdom and the United States.

tion liability are discussed below.[79] Two general issues need further attention here: problems of contribution avoidance and the status of officeholders. A third issue is that of excluded categories of employee or employment.

C. Independent Workers: Are They Employees?

Experience in many countries[80] shows that employees will be strongly tempted to claim to be self-employed if the liability to tax and social security contributions is greater for an employee than for a self-employed individual. This temptation is particularly marked when a high level of contributions or payroll taxes is levied on the employer. If an employer employs an employee, the employer contribution is payable. If the employee is instead taken on under a contract as a self-employed person working independently, there is no payroll tax. The saving to the employer may be considerable, even if the "employee" receives more money. It is also harder for the social security authorities to obtain a full contribution from a self-employed individual than from an employer. One solution to the noncollection problem is to levy a flat-rate tax on all payments made to persons in these categories, whether they are employees or self-employed. However, if the rate of withholding tax applied is too high, a genuinely self-employed person may be overtaxed because this approach makes no allowance for business expenses. This may not be a problem with genuine employees.[81]

This problem may require a case-by-case approach, with rulings being made for, and agreements being secured with, different groups of employers or employees. These agreements can reflect the fact that contributions and benefits are linked, at the state level if not at the individual level.

Experience also shows that the problem of sham self-employment is more likely to occur in some areas of activity than others. One solution is to provide special rules under which an individual is treated as an employee whatever the actual legal status of the person. This is done, for example, with those whose work involves neither high levels of skill nor the use of tools or equipment provided by the "employee." Examples are casual staff in a catering establishment or on a building site.

D. What of Officeholders?

The other general problem in defining employment is the status of an officeholder. An individual appointed to an office is not an employee and is not

[79]*See infra* sec. II(C–N).

[80]This has been experienced widely in the economies in transition, where there has been a sharp growth in alleged self-employment and a reduction of employment by large employers.

[81]This approach has been adopted in some states of the former Soviet Union and has been discussed in the United States.

self-employed because of the appointment. This applies to public offices such as judges, government ministers, or members of parliament. It applies to noncommercial positions, such as trustees of a charity or senior members of a religious organization. In addition, it applies to commercial organizations, in particular, to the directors of a company.

Many officeholders are in broadly the same position as an employee in that they earn their income by working in the positions they hold. Others are in the position of a self-employed person. For example, a lawyer who holds a part-time directorship in a company that is a client of the lawyer's firm so that the client may be given legal advice is in reality a holder of that office only as part of the lawyer's professional activities. Rules must be provided to deal clearly with these cases.[82]

The most difficult area is that of the individual who runs a small business through a company. An extreme, but not uncommon, situation is that of an individual who has a small business that she runs on her own and then turns into a small company. The individual owns all the shares in the company, is the managing director of the company, and works full time in the business of the company. The individual takes money out of the company as director's fees. She may also be paid as an employee of the company under an employment contract in addition to her status as director. She can also receive dividends. Is the individual employed, self-employed, both, or neither? If the company also employs the individual, then clearly there is an employment. However, what is the position of the individual as company director? Again, a clear rule is needed.[83]

E. What Categories of Employees May Be Excluded?

Employees may be excluded from a state's social security scheme for a variety of reasons. However, in any national scheme the reasons for exclusion should be objective. If the scheme is truly compulsory and universal, no one has a right to exclude an individual for personal or voluntary reasons. Therefore, those groups of employees that may be excluded from schemes must be noted. In each case, the rules for exclusion may apply differentially to the employee and the employee's employer. In this section, the exclusion of employees is addressed. The effect on their employers is discussed in the next section.

[82]International practice is inconsistent. Countries such as the United States and the United Kingdom treat officeholders in the same way as employees. *See supra* note 75. Some states, for example, Belgium, Germany, and Ireland, exclude directors (in Ireland, controlling directors) from the schemes for employees, but may bring them within the schemes available for the self-employed. 6 IBFD European Taxation, *supra* note 1, at Belgium 45, Germany 42, Ireland 49. This recognizes the problem in the text in the most general way.

[83]*See supra* note 82. The United Kingdom has a more specific rule under which director's fees paid to the director's firm (and not to the director personally) are not regarded as imposing contribution liability on the director, although for general purposes a director is treated in the same way as an employee. *See* Social Security (Contributions) Regulations, 1979, Regulation 19B.

1. *Age-Based Exclusions*

A general reason for exclusion is age. A scheme can apply an upper age limit and a lower age limit. In most schemes, those over retirement age (or pensionable age) become entitled because of age to a pension. Those receiving pensions are not required to contribute from those pensions. A series of subsidiary issues must also be decided to determine whether a person over pensionable age has any liability for contributions. For example, if a person is allowed to draw a pension but also continues to work, are the earnings from the work liable to contributions? A similar point arises when a person who could draw a pension on age grounds chooses not to, but decides instead to continue in full-time work. Should that individual pay contributions after reaching pensionable age? Again, what of the individual who, on reaching pensionable age, is, for some reason, not entitled to a pension and is therefore obliged to keep on working? In each case, the answer reflects both issues of funding and issues of fairness. It may be decided that, upon reaching pensionable age, an individual should, on age grounds, not pay any further contributions. On the other hand, it may be decided that contributions should be paid on all earnings, regardless of the identity (and therefore age) of the earner. The answer may also reflect any linkage between contributions and benefits. If the contributions of an individual over retirement age cannot earn the individual any further pension, then it may be questioned if they are truly contributions.[84] They may have become an income tax to be justified on other policy grounds. Alternatively, if the employee remains covered for some risks but not for others, a different rate of contribution may be appropriate.

Similar issues arise with young earners. Schemes may have a lower age limit. This may reflect a general rule of law preventing children below a certain age from remunerative work. As any child working below that age is working illegally,[85] it is administratively simpler to exclude any social security involvement in such cases. A second reason for a low age limit is an assumption of a lower limit to the working age used for the scheme. A lifetime scheme is based on all earnings of an employee of working age. The state, or the scheme, may assume that the working age starts at a certain age or when the individual is no longer required to attend school. If so, it may be appropriate on grounds of fairness and administrative efficiency to exclude an employee below that age, or still at school, from a requirement to contribute. Such contributions will not, in the normal course of events, be needed for the individual

[84]This is recognized in Sweden, where no contributions are required from or for pensioners, but where instead a salary equalization tax is payable. 6 IBFD European Taxation, *supra* note 1, at Sweden 49, 50, 52.

[85]With some exceptions; *see, e.g.*, Fair Labor Standards Act, § 13 (as amended), 12 U.S.C. § 213(c) (USA)(in certain circumstances, exempting from the child labor provisions children working on farms or as actors).

to get a full pension entitlement. Inclusion of such earnings may also encourage evasion or nondeclaration.

2. *Education and Training*

An issue related to a lower age limit is that of continuing education or training. This covers those continuing to pursue a full-time education or training after reaching the minimum age of the scheme and after having left school. In particular, those attending university or full-time professional training should be considered. The income of a student from a government or private scholarship is not usually regarded as earnings. A student may have a low level of casual earnings from, for example, part-time catering work, and it is for consideration whether such earnings should be within a system. A related question, beyond the scope of this chapter, is whether a student or trainee should be able to pay voluntary contributions to make up any "missing" years of contributions,[86] or whether contributions should be credited to the individual during training.[87]

3. *Voluntary and Nonremunerated Workers*

Other groups of employees (or those who might be regarded as either employees or officeholders) may also be excluded if they have no earnings or minimal earnings only. For example, members of religious orders or other organizations to which individuals offer their services voluntarily while having their immediate personal needs met, such as voluntary development workers, may be excluded.

[86]An individual who has a deficient contribution record because no liability to contribute arose (e.g., because the individual was on an extended holiday or had private income) is sometimes allowed to contribute voluntarily in order to make good the deficiencies in the contribution record. For example, the United Kingdom has a category of contributions (Class 3) payable on a voluntary basis in these cases. Social Security (Contributions and Benefits) Act, 1992, ch. 4, § 13. There may be advantages to the state in allowing this form of additional contribution as it may remove any obligation to provide means-tested benefits for an individual.

[87]If benefit entitlement in a scheme is subject to contribution conditions, consideration should be given to the crediting of notional contributions to the contribution record of an individual if the individual, for good reason, is not contributing. One example is the crediting of notional contributions during approved periods of education and training. If a contribution test for a benefit requires a minimum level of contributions in any period, or a minimum period of contribution, before benefit entitlement arises, then it may be necessary to allow for notional contributions in a scheme. Otherwise, for example, an individual who has just started work after an extended period of education or training may not be entitled to benefits. Similar problems arise for those who have been receiving benefits, for example, for illness or unemployment, for mothers on maternity leave, and for those who give up work to look after sick relatives. The provision of a notional contribution replaces the requirement that the individual pay a contribution either compulsorily or voluntarily.

4. *Recipients of Benefits*

A decision must also be taken about the contribution liability, if any, that arises from someone in receipt of benefits. For example, is someone who receives sickness benefits in place of earnings during a period of sickness liable to continue paying contributions toward a retirement pension? This can be a complex question in a state that has separate schemes for separate benefits and also depends on how a benefit is paid. If an individual is ill, her or his earnings may be kept in payment in several ways. The employer may allow the employee a number of days of sickness a year without loss of pay, the employer may have a specific private insurance scheme that makes good the pay, or the pay may be made good by the employer, who is then entitled to recoup from the state the amount paid. Finally, the employee may be entitled to claim a benefit direct from the state. This may or may not come from the same fund as that from which the retirement pension will be paid. Each method of providing the employee's benefit during sickness may suggest different policy reasons for requiring, or exempting, contribution liability on the sums received. There seems no strong reason to exempt if the funds come from the employer. Whether exemption should apply when sick pay comes from the same fund as a retirement pension may depend on how the real value of the sick pay compares with the pay before sickness.

5. *Specific Employments*

Approaches differ markedly among countries as to the scope of employments covered by social security schemes. In some countries, all employees are included in one universal scheme.[88] The one scheme therefore covers both public servants and private sector employees. At the other extreme are systems where each industry or profession has created its own scheme.[89] Decisions must then be taken about the coverage of each scheme. Intermediate positions may be adopted if some employments or industries have special schemes,[90] with those not covered by special schemes being within the general scheme.

If separate schemes exist for individual professions or industries, a separate approach may be taken to individual professions. For example, all those who practice a profession may be expected to join their professional scheme whether they are self-employed or are professional employees.[91] This approach forms an exception to the usual distinction between employees and the self-employed.

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[88]For example, Ireland and the United Kingdom.

[89]This is the French approach.

[90]For example, agricultural workers or members of the armed forces. *See supra* note 72.

[91]For example, Portugal, where the self-employed may choose which professional scheme is appropriate for them (on the basis of their activities). 6 IBFD European Taxation, *supra* note 1, at Portugal 61.

6. *Employment Within the Family*

As a result of income tax rules, it is convenient in some countries for one spouse to employ the other in order to deduct the salary paid. This may reduce the family's general liability to income tax. The same is true when parents employ their children or, more generally, when employment takes place within the family. It is to be considered whether such employments should also be regarded as employments for social security purposes. It might be decided that some forms of employment within the family should be ignored, for example, when one member of the family is paid to do the housework. This may technically be an employment, but it is unlikely to be a true commercial contract of employment. Therefore, it may be appropriate to provide for the exclusion from social security schemes of employments within the family other than genuine employment in a family business.

7. *Jurisdictional Exclusions*

A scheme needs to have rules for the inclusion or exclusion of employees whose work is not solely confined to the jurisdiction of the territory covered by the scheme. This topic is discussed separately below.[92]

F. Who Are Employers?

It is necessary to identify the employer in respect of any employment because the law imposes contributions directly on employers. The law also requires employers to act as agents for the social security authorities to collect contributions from employees. There is little difficulty in identifying the employer once the employee and the employment are identified. The employer is the other party to the contract of employment with the employee. If a definition is needed, then it might be simply stated that the employer of an individual is the person who employs the individual. Inevitably, there are legal and practical difficulties with this approach. For an officeholder, there is no employer in the legal sense. If officeholders are treated as employees, then the organizations of which they are officeholders must be assumed to be the employers.

Another practical difficulty occurs when an employee appears to have two employers. For example, Val works for company A. Company A instructs Val to work for company B for six months in another part of the state. Company A pays Val's expenses in moving temporarily to work with company B, but company B pays the salary and costs and instructs Val on the duties to be undertaken. Formally, company A is the employer, but in practical terms company B has become the employer, at least for the time being. Rules are needed to deem the paying company to be the employer. Alternatively, they may allow the paying company to act as agent for the employer, or the employer may recover the relevant social security contribution from the other company.

[92]*See infra* sec. IV.

As a result of the jurisdictional rules,[93] an employee will sometimes be within the jurisdiction of a scheme, while the employer is outside the scheme. This problem may be dealt with by imposing the liability to pay the employer's contribution on the employee (besides the employee's own contribution). Alternatively, if the employee has been seconded by a foreign employer to work with a business within the state, that business may be deemed to be the employer. The principle is that the person benefiting from the services within the jurisdiction should be treated as the employer although not technically in that position. This prevents abuse of the system and prevents employees from being uninsured when a risk is realized.

G. Allocating Contributions Between Employer and Employee

Almost all schemes place the cost of social security for employees on those employees and their employers. However, agreement has not been reached on the share of the contribution to be borne by the employee rather than the employer; nor do all schemes within a state follow the same pattern.[94] Some schemes, as a matter of principle, divide the contribution evenly between the employer and the employee and collect half from each.[95] Some share the contributions between employees and employers, with the state—or taxpayers generally—also contributing.[96] Several countries, including some economies in transition, share the contribution, but impose nearly all the burden on the employer.[97] Others impose the entire burden on the employer.[98] It is less usual to find the employee bearing the larger part of the burden, but this also happens.[99]

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[93]*See infra* sec. IV(B).

[94]*See supra* note 49 (regarding the example of Austria).

[95]This is the practice in the United States.

[96]This approach was originally pioneered by Bismarck in Germany in the last century and has been adopted by a number of other European states. It was also the approach in the United Kingdom, confirmed in the Beveridge Report in 1946, *Social Insurance and Allied Services*, 1942, Cmd 6404, although the Government began to phase out the public contribution in 1979, only to reintroduce it recently to deal with a pending deficit in the National Insurance fund.

[97]For example, Russia imposes all but 1 percent of the contribution on the employer. C&L 1995, *supra* note 1, at R-9. In Hungary, social security contributions are paid by employees (at 10 percent of their gross salary) and by employers (at 44 percent of gross salaries) up to certain limits. *Id.* at H-15. OECD members that impose the main contributions on employers include Canada and Finland. *Id.* at C-9, F-15-16. Current rates for each country are set out in 6 IBFD European Taxation, *supra* note 1, and C&L 1995, *supra*.

[98]For example, Bulgaria and Poland. This is also widely used as an approach for schemes to compensate workers for injuries at work.

[99]For example, this happens in Ireland and in the United Kingdom (in both of which the balance between employer's contributions and employee's contributions has varied from time to time). A particularly interesting example is the Netherlands, where the main burden was recently shifted from employers to employees. To compensate, employers were required to make an extra transitional payment to each employee. This payment is, for general purposes, treated as extra earnings, although its amount is laid down by the Government.

Some states have sought to add economic factors to the decision about the level of contributions imposed on employers.[100] In effect, this approach introduces an indirect state subsidy to certain employers, the burden of which can be borne by other employers (thereby further increasing the element of subsidy). It runs against both the insurance principle of social security schemes and the trend of reducing the elements of tax expenditures in direct taxes.[101]

Requirements for imposing contributions on employers and employees are examined below, but two issues of principle need to be addressed at this point. First, are employers and employees liable to pay contributions on the same base? The answer may vary from one scheme to another. In a system in which the state is not involved, and in which contributions are divided evenly between the employer and the employee, principle suggests that the same tax base should apply to both contributors. This is less evident in other cases. However, the answer may relate to a separate issue, that of the linkage—if any—between the contributions paid by or on behalf of an employee and the benefit entitlements of the employee. The linkage for benefits, such as pensions, normally relates to the employee's contributions only. That being so, any contribution liability of an employer that is not reflected in a matching liability of an employee means that funds are being collected with no related benefit entitlement.[102] If that happens, the state should be able to justify this in the context of the general funding and benefits of the scheme.

The other issue is whether the employee can be made liable for the employer's contribution if the employer does not pay. This relates to enforcement provisions and is covered later. It is similar to the problem, important for income tax, of collecting tax from a taxpayer who has already paid tax by withholding at source, but whose withholder has failed to pay the tax to the tax authorities. An additional question in social security law is whether, if contributions are not paid but should have been paid, the employee loses benefit. In a fully contributory system, nonpayment of contributions results in nonreceipt

[100]For example, Norway is for this purpose divided into five geographical areas, with different employer contributions in each area (0 percent in the far north). Argentina has abatements of contribution for employers in specific industries. The United Kingdom recently introduced a reduction in the employer's contribution when the employer takes on someone who has been unemployed for over two years.

[101]It is possible that such distortions might also amount to state aids or subsidies for international trade purposes. Treaty Establishing the European Community, art. 92. This may happen if the combined effect of the contributions and the benefits payable from those contributions involves a hidden subsidy of a national industry against foreign competitors or amounts to nationality-based discrimination. Such discrimination could be in breach of EU law. It is less clear whether it would fall to be reviewed under a nondiscrimination provision in a double taxation convention.

[102]An example is the recent imposition in the United Kingdom of a social security contribution on employers, but not on employees, related to the provision by employers of company cars to their employees. This reflects the absence of a general charge on benefits in kind in the United Kingdom. The employer contribution gives rise to no benefit entitlement. The charge is imposed by a Class 1A contribution. Social Security Contributions and Benefits Act, 1992, ch. 4, § 10.

of benefit. It is then in the employee's own interests to ensure either that the employer pays the contribution or that the employee can make good the default or can be treated as having made it good.

H. Should the State Contribute?

Contrasting views are taken about contributions paid by the state to a social security scheme. One view is that it is appropriate for all three parties to the employment relationship—employee, employer, and state—to contribute to social security funding.[103] The opposite view is that the state should be excluded from social security funds, which are financed by employees and employers without outside involvement.[104] The choice of approach is a matter for political decision. Recent experience shows that the threat of social security schemes going into deficit has sometimes required temporary state subsidies from general tax revenues.[105] The key issue is the extent, if any, to which it is considered appropriate to fund part of the social security scheme from general tax revenues. At the same time, how involved should the state be in running a scheme? The two extreme approaches tend either to involve the state heavily or to exclude it. In practice, the effect of the tax system on a social security scheme means that the position is less straightforward than these extremes suggest. For example, a state may subsidize a social security fund indirectly through tax allowances and exemptions. It may also control social security funds through conditions attached to such allowances and privileges.[106]

I. Basis of Contribution Liability

The liability to contribute may be decided either on a flat-rate basis or on a basis related to the income and (if they are subject to contribution liability) benefits paid to the employee by the employer. Flat-rate schemes were once common practice among developed countries, but they have largely been replaced by earnings-related contributions and are not discussed further here.[107]

[103]This is the original German model of social security, adopted by a number of other European countries.

[104]This is the approach adopted for the U.S. federal social security funds.

[105]In France, this was done through a new old-age solidarity fund levy. *France: Measures for Safeguarding Social Protection*, Trends in Social Security (ISSA), Nov. 1995, No. 9, at 13 (referring to law of Dec. 30, 1993). In the United Kingdom, it was done by reintroducing the subsidy to the National Insurance Fund from general taxation that had been abolished a few years before. *See supra* note 96.

[106]These issues are raised in the final part of this chapter. *See infra* sec. V(C).

[107]Denmark is the only OECD member now using a major flat-rate scheme for its Labor Market Supplementary Pension (ATP). The rate is not related to pay levels, but reflects the length of the work week of the individual. Those working over 27 hours pay the full premium (in quarterly installments), while those working from 18 to 27 hours pay two-thirds, those working 9 to 18 hours pay one-third, and those working fewer than 9 hours pay nothing. Public sector employees pay a lower contribution than others. ATP, Annual Report 4 (1993).

1. Gender Discrimination

Many schemes used to differentiate between the rates charged for male employees and the rates charged for females. As the working conditions for males and females come closer together, and benefit entitlement rules such as retirement ages are made uniform,[108] any economic justification for this form of discrimination is removed. It is often prevented by general principles of law[109] or by general labor laws that prevent discrimination based on gender. This and other forms of discrimination may also be subject to human rights equality provisions.[110]

2. Earnings-Related Contribution Rates

Earnings-related contributions are justified by a need for revenue to finance benefits. They are also justified on the same basis as progressive income tax, by reference to redistribution through the tax system. However, the redistribution does not usually involve progressive rates of contribution. Rather, it occurs through the combined effect of the contributions system and the benefits available. In practice, because of links between contributions and benefits, a progressive rate structure would be irrelevant to many schemes. However, some states have a progressive element in the rate structure.[111] The effect of thresholds and caps (see below) can be progressive or regressive, but this is best viewed along with the benefits available to contributors and with the tax position of these individuals to get the full picture.

Income tax systems commonly have thresholds below which payments are not required. This approach is also used in some social security schemes. Income tax laws usually specify an amount that can be earned annually before tax is payable. Alternatively, the law may grant a refundable credit against tax

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[108]One justification for the distinction could have been the lower retirement age of women in many countries. However, in practice, men were required to pay higher contributions despite having the higher retirement age, indicating that this was not the reason for the discrimination. Another factor could be policies to encourage employment of females. If so, that policy aim has now been fulfilled in several developed countries.

[109]For example, under the constitutions of individual countries. It is prohibited in the EU member states, inter alia, by the Treaty Establishing the European Community. EEC Treaty art. 119. The equal treatment policy is more fully implemented by EC Council Directive 79/7 of December 19, 1978, on the Progressive Implementation of the Principle of Equal Treatment for Men and Women in Matters of Social Security, 1979 O.J. (L 6) 24. Article 4 deals explicitly with contribution liability. *Id.* art. 4.

[110]General statements about nondiscrimination in social security are set out in the European Social Charter, Oct. 18, 1961, art. 12, 529 U.N.T.S. 89; the United Nations International Covenant on Economic and Social Rights, Dec. 16, 1966, art. 9, 993 U.N.T.S. 3; and similar agreements.

[111]Colombia imposes on the highest-paid employees an extra 1 percent contribution to the state Social Security Institute. C&L 1995, *supra* note 1, at C-61. More unusual is the approach of the United Kingdom, which has a single rate for most employees (with a lower rate for earnings below the threshold), but has five rates of contribution (including zero) for employers, dependent on the level of total earnings of each employee. Social Secutity (Contributions and Benefits) Act, 1992, ch. 4, § 9 (as amended from year to year).

payable. A refundable credit system is not appropriate to social security, as it in effect combines liability and benefit. A social security system with a threshold, therefore, uses an exclusion of liability if income totals less than a set sum during the relevant period.

The adoption of a threshold is a compromise between the insurance role of a social security scheme and the recognition of both the administrative burden of imposing contributions on all earnings[112] and the effect this may have on the lowest earners. Insurance considerations suggest that all earnings should be included, while thresholds are justified by both practical reasons and policies of supporting the poorest earners. In many states, the insurance approach prevails and there is no threshold. If thresholds are adopted, the conflict of policies may result in a level of threshold that is lower than that operating for income tax.[113]

A threshold may work in two ways.[114] The most straightforward way is to exclude from liability to contribute anyone earning less than the amount set as the floor. Once that person's earnings exceed that sum, the floor is ignored and contribution liability is based on total earnings. This method has a distorting effect when earnings are near the level of the floor. The imposition of full contribution liability on someone whose earnings just exceed the floor may appear to penalize that person compared with someone whose earnings are slightly lower and who has no contribution liability. A small increase in gross earnings will result in a reduction of net earnings. This step effect would also exacerbate the poverty trap.[115] To avoid this, earnings below the threshold are typically exempted from contribution liability for contributors at all levels of earnings. Alternatively, there may be a special lower rate of contribution for earnings below the floor level. The price of this method of avoiding the step as earnings exceed the floor is a major reduction in the earnings base. This will require a higher rate of contribution on earnings above the floor level.

A threshold to contribution liability has two effects. At the general level, it avoids collecting small amounts and levying contributions on the poorest members of society. In this way, it has broadly the same effect as a personal allowance for income tax purposes. It also excludes a low-paid individual from the social security fund. This may mean that the individual is unable to claim from the fund, either because the individual is not a contributor or because the individual is unable to make enough contribution payments to meet the con-

[112]The burden is less important if contributions are collected entirely from employers (or through employers) and are based on payroll levels. In such schemes, the introduction of an individual threshold adds to employer compliance costs.

[113]In the United Kingdom, the income tax threshold and contributions threshold were set on different bases in 1975. Their levels are determined from year to year mainly on the basis of indexation, so the difference has been maintained.

[114]Another alternative is the provision of a credit against income tax, which may be related to a greater or lesser extent to the amount of social security contributions. *See* USA IRC § 32 (regarding the earned income credit).

[115]*See infra* sec. V(D).

ditions for a benefit. Whether a threshold represents the best compromise of efficiency and justice then depends on any means-tested or universal benefits available in place of the contributory benefit. Exploration of that issue is beyond the scope of this chapter.

Unlike income tax, social security schemes often have upper limits, sometimes known as caps or ceilings. Capping occurs primarily with benefit entitlement, because schemes need to have an upper level of replacement earnings payable to contributors. This often results in the adoption of a cap or ceiling on earnings covered by contribution liability.[116] A cap on earnings is the upper amount of earnings on which contributions are based for the year or other period of liability. Any earnings over the cap are therefore not subject to contributions.[117] In a contributions-based and earnings-related benefit scheme, a cap ensures a maximum level of benefits to any individual or from any one source of earnings. This prevents a disproportionate amount of benefits from being paid to those with very high incomes.[118] However, if benefits are capped but earnings are not, an overtly redistributional element is included in the scheme.[119] Conversely, caps may have a regressive effect on the overall tax/contribution position of employees.[120]

3. *Earnings Bands*

An alternative to applying a percentage to earnings is to determine the amount of contributions by using a banding system.[121] This scheme sets a series

[116]Two examples are the U.S. federal scheme and the German schemes. The German schemes have higher upper earnings levels for the former west German states than for the former east German states. C&L 1995, *supra* note 1, at G-10; *see also* Messere, *supra* note 1, tbl. 8.1, at 183 (listing caps in the following OECD members: Austria, Canada, France, Germany, Greece, Japan, Luxembourg, Turkey, and the United States); *see also* Messere, *supra* note 1, at 177–78.

[117]A variant on this is to exclude entirely those employees whose earnings exceed the cap, on the ground that they do not need compulsory insurance cover. For example, in Malaysia, employers are required to pay to the state scheme for employees whose earnings are below a set level and are required to take out local liability insurance for those above the level. C&L 1995, *supra* note 1, at M-28 (citing the Malaysian Employees' Social Security Act, 1969); for current rates, *see id.*

[118]For example, if directors of small but profitable private companies are regarded as employees, they may be in this position, as may highly paid expatriates working in low-wage economies. These problems are sometimes dealt with by excluding such groups entirely from the schemes. For example, Belgium treats directors as self-employed. 6 IBFD European Taxation, *supra* note 1, at Belgium 45. Ireland excludes controlling directors from the social insurance scheme. *Id.* at Ireland 49.

[119]Caps may sometimes apply to employers but not to employees (as in the United Kingdom) or the reverse (as in Ireland).

[120]This is expressly dealt with in the Netherlands scheme, which applies higher rates of income tax to those not paying the social security tax, to produce a combined rate of payment of both income tax and contributions on a progressive basis. 6 IBFD European Taxation, *supra* note 1, at Netherlands 43.

[121]For example, in the Philippines. For current Philippine bands, *see* C&L 1995, *supra* note 1 at P-58-59. The banding system is analogous to the use of tax tables for individual income tax. *See* vol. 2, ch. 14.

of levels of premiums, each applying to a band of earnings. For example, those earning between, say, \$30,000 and \$39,999 pay a premium of one level (perhaps based on a given percentage of \$35,000). Those earning between \$40,000 and \$49,999 pay a higher premium (perhaps the same percentage of \$45,000). The lowest band may start at a bottom figure other than zero, thus incorporating a threshold into the system. Similarly, the top band will expressly or indirectly build an upper limit into the system.

A banding system may be seen as having advantages in that it avoids an excessive need for accuracy. Earnings of \$35,000 and \$37,000 both give rise to the same premium. This effect reverses near the limits of the bands and can have very sharp consequences. Someone earning \$40,000 will pay a higher premium than someone earning \$39,990. Further, the extra amount of premium may be greater than the extra earnings. As a result, the person earning \$40,000 may actually receive less than the person earning \$39,990. This effect can be reduced by having a larger number of bands and a smaller difference in premium between bands. Any attempt to increase the number of bands will also increase the administrative complexity.

J. What Are Earnings?

A compulsory earnings-related contribution is in all but name an income tax if imposed directly on the employee. It is essentially a payroll tax if imposed directly on the employer. How much should the definition of "earnings" that are liable to an earnings-related contribution vary from the definition used for liability to income tax? There is little reason in principle why the measurement of income used for income tax purposes and that used for contribution purposes should differ. This is so whether the reason for basing the contributions on income is that it reflects ability to pay or that the benefits are earnings related. In both cases, income should include benefits both in cash and in kind. Again, in principle, any deductions permitted should be parallel, save perhaps for deductions for the payments of income tax and contributions themselves.

1. Links with Income Tax

There is a strong practical reason for ensuring a close identity between earnings for income tax purposes and earnings for contribution purposes. It minimizes the legal, administrative, and compliance burdens of collecting two parallel payments from employees. This identity should, if possible, be provided for in the law itself. The legislative terms used for imposing the income tax and the social contributions should be the same unless a difference is intended. Careful consideration should also be given to ensuring that the terms receive consistent interpretation and application by those responsible for administering and supervising the collection process. Failure to ensure this will

almost inevitably lead to variations appearing in the operation of the income tax and contribution rules. This is an added level of complexity for both employer and employee, as well as a duplication of official effort. Unless dictated by clear policy reasons, any differences of approach are inefficient.

An additional level of complexity may be introduced by an appeals process. If decisions about the application of income tax legislation and social contribution legislation are dealt with differently, differences in interpretation may appear. One solution is to link the contribution legislation to the income tax on earnings. This link can be comprehensive, with the same rules operating for both income tax and contribution purposes.[122] If this link is established, an appeal on an income tax question is automatically an appeal on the contribution question (and the converse is also true). The same position must then be maintained for any official rulings and guidance. That might best be achieved by providing that the guidance offered by the income tax authorities also applies to contributions.

2. *Reaching Settlements*

Objectives of income tax systems and social security systems are different. If the income tax authorities have power to deal with practical contribution questions in this indirect way, should they be aware of the different objectives and requirements of the contribution system? This issue is important if the income tax authorities can reach settlements and compromises with an employer over the tax liabilities of the employer's employees. For example, an employer may be found to have misrecorded and underpaid employee income tax and contributions, accidentally or otherwise. The interests of the tax authorities are to make good the loss to the public revenue, for example, through a global settlement of liability with the employer, including a penalty element. The same approach may not be sufficient for contribution purposes because the contributions that should have been paid for or on behalf of the employees can count toward their benefit entitlements. A global settlement does not make any provision for attributing lost contributions to individual employees. That can be done only through a series of individual settlements. It is probably not in the interests of the tax authorities to engage in that level of supervision and negotiation. However, it is in the interests of the individual employees and, therefore, of the social security authorities.[123]

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[122]This is subject to specific differences caused by the different natures of the two payments. This approach is used, for example, in Sweden. 6 IBFD European Taxation, *supra* note 1, at Sweden 49. This applies in the United Kingdom to contributions paid by the self-employed, where the amounts are expressly based on the assessed profits for income tax purposes. Social Security Contributions and Benefits Act, 1992, ch. 4, § 15 (regarding Class 4).

[123]These questions have recently been the subject of unpublished, interdepartmental review in the United Kingdom. It was concluded that the scope for further combining these aspects of the tax and contribution schemes was limited.

The example of compromises affecting the integrity of the contribution records of individual employees applies equally to any process of estimation or compromise in the tax system. It may also apply when the tax authorities declare an amnesty or otherwise decide not to enforce the law strictly. It may be in no one's interest to seek the strict enforcement of the income tax law. Contribution liability has the added dimension of the need to protect the employee's contribution record. A compromise may therefore involve the employee paying contributions but receiving no benefits. In practice, many such compromises result in little unfairness to individuals because little benefit is lost. The main concern is that the extent of this loss cannot be calculated at the time. The loss of only a small part of a contribution record may have major effects on one individual, but no discernible effects on others. In any system that collects contributions over the lifetime of a contributor, there is no easy solution to this clash of principles. It can be avoided in part by ensuring that the liability rules are effective and consistently applied and that the temptation to cut corners is avoided. However, it must also leave open the position of the social security authorities not to accept compromises of the income tax authorities that are not consistent with the principles of the social security system.

3. *Benefits in Kind*

Identical treatment of earnings paid in cash for income tax and contribution purposes generally poses no major problems and is desirable. Further attention may be needed to the treatment of benefits in kind and of any allowances and deductions from earnings. In part, this depends on the details of the income tax system, discussed in volume 2 of this book and not repeated here.[124] It may be possible to use for contribution purposes the same method whereby benefits in kind are made liable to income tax, including the timing rules.

4. *Specific Expenses and Allowances*

Different issues of policy may arise for the allowance of deductions for specific expenses and allowances. The personal allowances in income tax are sometimes designed for social purposes, and their replication in social security schemes may serve to defeat rather than reinforce those social purposes.[125] Other allowances, such as those for certain forms of saving or expenditure, may be regarded as inappropriate in a social security context. Genuine expenses of

[124] *See* vol. 2, ch. 14.

[125] For example, a disabled person may receive additional income tax allowances. If the person also receives a reduction in contribution liability, then the individual may also receive reduced benefits when it would be better for the individual to pay the contributions and receive the full benefits.

employment if allowed for income tax purposes should probably also be allowed for contribution purposes. If deductions are allowed, then efficiency argues for allowance on identical terms and subject to the same procedures.[126]

One area of difference cannot normally be avoided. This is the income tax treatment of contributions and contribution treatment of income tax.[127]

5. *Practical Effects*

The use of different definitions of earnings for tax and contributions purposes either in law or in practice imposes practical problems on employers. This is because any differences result in the need for the employee or employer to keep different sets of records for each employee. They must also provide different returns to the two authorities. This may be only a limited problem for an employer with an automated payroll if the two sets of rules are clear and easily administered. However, it neither avoids the cost associated with the need to supervise a continuing duplicated operation nor deals with the resulting problem of having two teams of officials wishing to audit the employer's records for their own purposes. The problem of accurate compliance is significantly greater for smaller employers who lack trained staff and facilities for automation.

As a general matter, the importance of achieving uniformity among income tax and contributions, in terms of both legal provisions and administrative arrangements, will vary from state to state depending on the operation of both the income tax and the contributions systems. The discussion in this chapter assumes a substantial overlap in the groups that contribute to the two systems. One can, however, envisage situations where this is not the case, for example, where contributions cover wage earners generally, while income tax may involve only a small number of individuals because of a large zero-rate threshold. Because of differences in local circumstances, the considerations discussed in this chapter may have different implications for different states.

K. How Should Rates of Contribution Be Determined?

A major difference between income tax and contributions lies in the rates of payment, including any allowances. There is no direct correlation between income tax rates and contribution rates. As noted previously, rates of contribution liability are not usually progressive. Their levels will depend above all on how the overall social security scheme is funded. At one extreme are pay-as-you-go schemes that fund existing benefit entitlements from existing contributions. At the opposite extreme are schemes that fund a person's benefits

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[126]For example, an employee may be allowed to deduct any genuine employment costs, such as special clothing or travel costs. It is clearly most efficient to check on the extent that such claims should be allowed in the same way for both income tax and contribution liability.

[127]*See infra* sec. V.

only from contributions made by or for that person. Between these extremes are funded schemes where contributions are pooled and schemes that rely on reserves held against future liabilities.

Rates are also linked with thresholds or caps to liability. Unlike general taxation, the rate or rates of contribution are based on the revenue needs of the fund to which the contributions are paid. There is normally a direct link between the actuarial estimates of liabilities of the fund and the estimated income to the fund for any given rate of contribution. The rate is dictated by professional advice on the required levels of contribution to fund the outgoings for the period.

Determination of the rate or rates of contribution is therefore not a matter of fiscal policy under a funded benefit scheme. Rather, it should be the result of the exercise of expert judgment of the actuaries, who will base their estimates on relevant demographic data relating both to the contributing membership of the fund and to the benefiting membership. Their decisions will allow those in charge of the funds to identify actual and likely income and expenditure over both the immediate future and the long term. A decision on the precise recovery of costs in any one year is a political decision to be based on actuarial advice.[128]

L. Earnings Periods

Direct taxes are normally determined annually. However, income tax on earnings is often collected by means of a preliminary or withholding tax. There may or may not be an annual adjustment to ensure that the proper amount of tax is paid over the year.[129]

1. *The Income Tax Year*

There are obvious advantages to using the same basis of collection for income tax and for social contributions.[130] The advantages apply whether the contribution liability is that of the employer, the employee, or both. When the same base periods are used, income tax and contributions are collected together and follow one set of calculations, thereby reducing administrative and compliance costs of collection. If identical rules are used for income tax and for contribution liability, the annual calculation of social security contribution

[128]This has two awkward effects for those collecting contributions. One effect is regular changes in contribution rates. The other effect is that contribution rates are often expressed to one or two decimal points. For example, in Sweden, the 1994 rate for employees was 31.36 percent, and that for the self-employed was 29.75 percent. It also leads to small changes of rate from year to year.

[129]*See* vol. 2, ch. 15.

[130]Many countries, including the United States, Germany, and Sweden, base contributions on annual earnings (often linked to the calendar year).

liability will share most of the other advantages and problems of income tax liability. It is easier to ensure an accurate and fair total assessment of contribution liability for the year. For example, the use of identical rules allows for easier adjustments for benefits in kind provided by the employer, with minimal administrative burdens on either the collection authorities or the employer. It is also easier to provide an accurate and transparent record of the total contributions to be paid and the basis for that total.

These advantages may be offset by a need to relate contribution periods to benefit computation periods. If the benefit year and the income tax year are not the same, administrative problems may arise in calculating benefit entitlement of contributions. It may also be necessary to ensure that contribution liability gives rise to benefit entitlement where entitlement depends on contribution conditions.

If, because of annual calculation, contributions are collected only after an assessment has been made, there are significant disadvantages to all concerned. Collection with each payment of earnings has obvious cash-flow advantages for the scheme. It also minimizes the delay between receipt of earnings and the contributions payable on those earnings and reduces problems of avoidance and bad debts. Furthermore, it ensures that an individual has a full contribution record at any time for claiming a benefit entitlement subject to a contribution condition. This suggests that a preliminary or withholding tax has significant advantages for contribution liability.

2. *Separate Earning Periods*

An alternative approach is to collect contributions on a final basis as earnings are paid.[131] Each earnings period is treated as a separate assessment period, either exactly or by reference to a weekly, monthly, or similar period. If a pure earnings period basis is used, then each payment of earnings is subject to deduction of the appropriate contribution liability. If a flat-rate contribution is used, the weekly or other period for which each contribution is paid can be imposed over the payment pattern used for the employee with little difficulty. When contributions are related to earnings, adjustments are needed. If earnings-related liability to contributions is based on anything other than a straight percentage of the total earnings of the contributor, the liability in respect of any payment of earnings must be calculated by reference to the precise period for which the earnings are paid. Often, payment is by reference to a day, a week, or a month, on a recurring basis, presenting few difficulties. The earnings period basis causes problems when there is no clear pattern of payment and when contribution liability can be avoided through manipulation of the relationships between payments and earnings periods. For example, the exist-

[131]This approach is used in the United Kingdom.

ence of lower earnings limits and upper earnings limits creates distortions if uneven payments or earnings periods are used.

The main advantage of an earnings period base for calculation is that payment of contributions for each earnings period is final and not subject to adjustment, eliminating the need for an annual return. A contribution can therefore immediately be counted toward satisfaction of contribution conditions for benefits. The main disadvantage is that it is not possible to make an annual adjustment to reflect uneven patterns of earning or uncertainties. Similarly, if the income tax system contains annual adjustments, these cannot easily be assimilated into a pattern of short earnings periods. One practical result may be the need for antiavoidance provisions to override the finality of contribution payments when it is established that payments are being manipulated for avoidance or evasion.[132] This may require an annual review period. In effect, it solves the problem of avoidance by removing the earnings period basis. The same is true if annual adjustments are made to reflect, for example, benefits in kind.

One way of dealing with the conflicting advantages and problems of the annual basis of income tax and an earnings period basis for contributions is to apply two or more kinds of contribution to earnings. Cash earnings can be assessed separately with each payment. Other benefits and adjustments can be collected on an annual basis.

A further complication with the earnings period basis of collection is that many employments have inappropriate earnings periods or, alternatively, no regular basis of payment. A daily basis is unlikely to be practicable; for practical reasons a minimum earnings period of a week should be established. Monthly payments are technically not regular, but may be assumed to be such. A pay pattern that is part weekly and part monthly (e.g., a weekly basic wage with a monthly profits-based bonus) causes practical problems. Also, irregular payments or payments made for regular periods at irregular times cause problems. A scheme adopting the earnings period basis for collection must also adopt a clear set of rules to decide in every case the relevant earnings period in respect of any payment made. Further, these rules must be easy to implement with a minimum of official guidance. It is likely that both antiavoidance rules and a default rule will also be needed.

The complications of operating an earnings period basis of contribution liability are, however, likely to be confined to the unusual case. In the usual case of regular weekly or monthly payments of earnings that are subject to contribution liability on a set percentage basis, the imposition of contribution liability on a final earnings period basis has several advantages. The balance

[132]For example, directors are treated in the United Kingdom as employees. However, because they can often control the way in which their companies pay them (e.g., by loans, rather than earnings, or by erratic pay practices), they are assessed on an annual basis and not by relation to earnings periods.

between what is usual and what is unusual must clearly be important in deciding on the balance of advantages for the choice of contribution liability period.

The identity of income for both income tax and contributions purposes is also subject to any practical restraints imposed if there are different timing rules for the two payments. Income tax is usually an annual tax. If contribution liability is based on shorter periods,[133] then the system needs methods of determining income that do not involve annual adjustments of the kind found in income taxes. For example, annual personal allowances or credits cannot be operated for shorter periods without some form of amendment or annual adjustment. Similarly, adjustments to take account of benefits in kind must be capable of being made within the contribution period. The timing rules will themselves depend in part on the method, if any, used to link contributions to benefit entitlement. One practical issue is that a benefit entitlement cannot be based on a contribution test that remains indeterminate at the time of benefit claim.

M. Multiple Employments

The traditional pattern of work in most forms of economy has been that individuals are engaged in full-time work with one employer for extended periods. In economies with strong service elements, and economies experiencing high levels of unemployment in recent years, this tradition has weakened. Individuals are more likely to change employments, and areas of employment, than in the past. There are also many more part-time jobs. Both raise issues that need to be considered in formulating contribution policy.

Often, a change of employment by an employee creates no problems. If there is a period of unemployment, then unemployment benefits may be payable. Contributions may not be payable with respect to the unemployment benefits.[134] Problems may arise if, because of the change of employment, the individual comes to be employed in a different scheme from the one in which he or she was previously employed. This may involve a need either to transfer funds between schemes or to provide for some overlapping or cross-financing between schemes. The fewer the schemes run by a state, the lower the number of problems caused by such changes.

An associated change for which procedures may be necessary involves a person who ceases to be employed and becomes self-employed. This is dealt with in the next part of the chapter, as is the case of a person who is both employed and self-employed at the same time.

Another problem is that of an individual employed in two employments at the same time. This may occur at all levels of the employment market, from the person who is a director of several companies to the casual worker provid-

[133]*See supra* text accompanying note 131.

[134]*See infra* sec. V(C).

ing his or her services—for example, as a cleaner or temporary office worker—to several different employers during a work week. Some individuals who supply services to several employers at once are properly regarded as self-employed, but this is often not so. For example, someone providing cleaning services will usually be under the direct control of the person paying for the services and is properly regarded as an employee. In principle, an employee with several employments should be separately liable for contributions from each. Consequently, each employment during the week requires separate consideration. This is potentially a heavy administrative burden. It is also likely to lead to avoidance of contributions.

When the employments are all by the same employer (or employers that are connected with each other), the simplest answer may be to treat all the employments as if they are one employment. The problem may also be avoided if one employment is, or is nominated as, the "main" employment, with the obligations of contribution being imposed on the employer for that employment. If the scheme has a cap for contributions, this may be met in full by the main employment. Other employments can then be ignored (but only if the scheme is prepared to lose the employer's contribution in respect of those employments). The problem may also be avoided if there is a minimum level of earnings from any one employment before contribution liability arises.[135]

Special rules can be used to deal with those who provide their services through an agency. If individuals, although technically not employed by an agency, provide their services to their employer through an agent, then the agent may be deemed to be the employer and may be required to account for contributions on behalf of all those paying the individuals. This may be effective if the agent (as often happens) collects fees from the employer and is responsible for paying the individuals.

However, these are only partial solutions. They require a complex set of rules, but the liability of employees and employers to contribute in respect of multiple employments of an employee at the same time must also be established to avoid revenue loss and inequity.

N. What Records Are Necessary?

Special consideration needs to be given to the records to be kept of contribution payments.[136] Employers are subject to the normal requirement, in

[135]However, a consequence may be that the individual is left with a reasonable level of total earnings, but with no obligation to contribute and possibly no entitlement to benefit.

[136]ISSA has produced a series of useful booklets on these topics. *See Collection of Contributions* (1994), *Enforcement and Compliance* (1994), *Maintenance of Records* (1994), and *Registration Procedures* (1994). ISSA also provides training courses and support materials on these issues.

parallel with income tax, to keep records of all payments to employees and contributions collected from employees. In addition, central records must be kept of each contributor's contributions. This may require additional record keeping by the employer. It needs a fully coordinated single record-keeping facility for each scheme and protection of the integrity of the data recorded. These requirements should be reflected in the legislation. The data recorded must reflect all contributions paid by or for individuals that are or may be relevant to benefit entitlement. If notional contributions are added to the individual's record, these should be recorded as well.

The central recording requirement means that the social security administration needs to have a unique identifying number for each contributor. This is usually achieved by assigning each contributor a number, the individual's social security number. The number will also be of use to the social security benefit administration. In practice, employees also need identifying numbers for income tax purposes. It is much simpler if the same number is used for both income tax and social security purposes. The number may be assigned by either the social security administration or the tax administration.[137] A further alternative is to assign a national identification number to the individual, perhaps when the birth of that individual is registered or when the individual reaches school-leaving age.[138]

Each individual needs to be assigned his or her number personally. All employees should be required to supply their social security numbers to their employers. The records kept by employers can then be related to the central records with the minimum of problems. The numbers can also be used as a useful cross-check between income tax records and social security records.

The need to protect the integrity and accuracy of the contribution record of individuals over their lifetimes imposes a significant administrative burden on those administering a contribution-based social security system. The level of accuracy required depends on the precise relationship between contributions and benefits. Any close relationship imposes an original and continuing need for accuracy. It means that the data on the record should not be open to alteration or adjustment for any reason save by due process of law.

[137]For example, it is assigned by the social security administration in the United Kingdom and the United States. Because of the social security and health needs of children, it is likely that the social security authorities will need a number for an individual before any requirement arises for income tax purposes. Further, it is unlikely that an individual will get by without needing a social security number at some stage in his or her life. Many individuals may never become income tax payers. The use of a single identification number may raise privacy concerns in some countries, as it has done in Hungary according to a recent ruling of the supreme court. In such cases, special protections for privacy may have to be provided in the legislation to meet these concerns.

[138]Many of the issues are the same as those for income tax, VAT, and other official numbers, also discussed elsewhere in this book. *See supra* ch. 6, sec. II(D).

III. Issues for the Self-Employed

A. What Is Self-Employment?

The self-employed form a significant[139] sector of every national workforce unless the national economic system imposes a state monopoly on conducting business. The sector includes both those who are genuinely in business on their own and those who conduct their economic activities in partnership or joint venture with others. Only if the form of business structure used itself has legal personality will the position of the proprietor of a business be converted into that of an employee or officeholder (director) rather than that of an independent worker. The position of the self-employed is particularly important in the service industry. Some professions, for example, lawyers, may prevent their members from becoming employees. In other areas, for example, small farms or restaurants, companies are not the usual form of conducting business. The technical distinction between employment and self-employment in marginal cases has been discussed previously.[140]

In addition to those who are fully self-employed, there are also those who provide consultancy or other services aside from and in addition to their ordinary employment. This applies equally to anyone who, for example, makes money by writing or engaging in artistic or creative activities or who engages in farming activities in addition to paid employment elsewhere.

The social security risks involved in insuring a self-employed contributor may be different from those for an employee. For example, a self-employed individual cannot become unemployed in the normal way, because he or she cannot be dismissed from or resign a job. Closing a business down is legally a different action and may lead to the realization of a capital gain or loss. However, a self-employed individual whose business fails may be unemployed. There is no set retirement age for a self-employed person. The self-employed frequently carry on working into older age. Further, they may have capital invested, or earned by way of goodwill, in the business that can be realized to provide a personal retirement fund. These considerations have led states to provide more limited schemes for the self-employed or to remove them from the scope of compulsory schemes altogether.[141] However, the tendency is to broaden schemes to include them.[142]

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[139]It is a growing sector in many economies and is large in many developing economies, particularly if account is taken of those engaged in farming and fishing. For example, Korea, in 1995, decided to bring farmers and fishermen within its compulsory schemes for the first time, increasing the number of scheme members by 2 million. *The Republic of Korea: Proposal to Extend Compulsory Coverage*, Trends in Social Security (ISSA), Apr. 1995, No. 7, at 9.

[140]*See supra* sec. II(B).

[141]For example, the Netherlands requires the self-employed to be members of some schemes but not others (health and disability insurance are excluded, as is unemployment insurance). Spenke, *supra* note 35, at 87–89. The self-employed who were previously wage earners in Denmark may, on a voluntary basis, continue their membership of the state supplementary pension scheme. ATP, Annual Report, supra note 107, at 4.

[142]As, for example, in Korea. *See supra* note 139.

Both the income tax liability and the social security contribution position of an individual who is self-employed are fundamentally different from those of an employee. There is no employment relationship and therefore no employer who can be asked to pay or collect income tax or contributions; nor, in most cases, can an employer be deemed to exist.

As a technical matter, some individuals who are employees may be treated as self-employed for contributions purposes. In schemes that impose some or all of the contribution liability on the employer, some employers may be exempt from tax generally, so that a contribution liability either cannot, or cannot conveniently, be imposed on them. Their employees can therefore be treated as self-employed so that they become responsible for contributions.[143]

B. What Is the Income of the Self-Employed?

The earnings of a self-employed individual are defined by reference to the actual or assumed net profits of the business. Income tax is payable on these, as defined by the relevant tax laws. At a policy level, there is little reason to define the profits of a self-employed individual differently for contributions purposes from the definition used for income tax purposes, save for the effects of the tax and social security systems themselves.[144] A consistent definition is particularly appropriate if the income tax law itself relies on the definition of profits used for commercial accountancy purposes.[145] The idea of separate definitions of "income" for social security purposes and for income tax purposes seems unnecessarily complex for the individual, but also devoid of justification by reference to the principles on which profit is normally defined. However, the underlying income of the activity may need adjustment between tax and social security liabilities to deal with specific allowances and provisions.

It follows that the definition of both income included and business deductions allowed under income tax law is entirely relevant for social security purposes, save for three aspects. The most important of these is that the focus on earned income as against investment income of the self-employed in income tax laws varies.[146] If social security benefits are designed to be earned income replacements, then the nonearned income of an individual is irrelevant. The profits of an active partner in a business are relevant, but the profits of a sleeping or inactive partner are not. Similarly, the profits of an individual actively renting or leasing accommodations to others (e.g., short-term holiday

[143]*See, e.g.*, USA IRC §§ 1402(c)(2)(c), 3121(b)(15) (regarding employees of international organizations).

[144]For example, when a self-employed individual claims allowances for tax purposes that do not form part of the commercially determined profit of the business, such as a tax holiday.

[145]For example, in Germany. *See* vol. 2, ch. 16, appendix.

[146]*See* USA IRC § 1402(a), (b) (defining self-employment income). Compare the approach of IRC § 911(d)(2) (definition of earned income), which limits earned income to 30 percent of net profit in the case of a business in which capital is a material income-producing factor.

accommodation) may be regarded as earned. The profits derived from investment property (e.g., an office building leased on the terms that the tenants carry out all repairs and pay all service charges) may be different. These differences may also be relevant for income tax purposes (e.g., they may affect eligibility for capital gain treatment on disposition of the property used, or in a schedular system may affect the schedule under which income is taxed). A clear definition of the scope of income to be included in, and excluded from, the contribution liability of an individual is needed to remove all cases of doubt.

The other distinctions are the treatment, in defining profits, of the payments of contributions, income tax, and any related insurance or pension contributions or premiums, and special allowances for tax purposes that are inappropriate for social security purposes.[147]

C. How Is Contribution Liability of the Self-Employed Based?

For the reasons just outlined, the social security contribution position of a self-employed individual is often different from that of an employee. Insofar as it depends on the income tax laws, the calculation of earnings must reflect the different income tax rules. The effect in most cases is to delay any contribution liability until the net profits of the individual for each accounting or tax year can be established. The only ways to claim a contribution in advance of this are to demand a flat-rate contribution or to attribute a notional income to the individual.[148]

Because the entire contribution of a self-employed individual must be paid by that individual, it may seem to be a higher rate than that of employees. It may prove inappropriate to impose full contributions on the self-employed for reasons noted previously. For example, the self-employed may be required to contribute only to basic minimum pensions and not to a full earnings-related scheme. If the self-employed receive the same benefits as employees, any reduction in the contribution of the self-employed may amount to a cross-subsidy by employees and their employers. If the net cost of contributions of the self-employed is reduced by allowing income tax relief, the effect is partly to shift the cost to general taxpayers.

D. What Records Are Necessary?

The same general points about record keeping and registration apply to the self-employed as to employees. The duties to register and to pay the contributions must be placed on the self-employed themselves. The collection of contributions cannot generally be imposed on those making payments to the

[147]For example, tax holidays.

[148]*See, e.g.*, USA IRC § 6513 (regarding the timing of advance payments).

self-employed.[149] Excessive deduction might take place, and the contributions might not find their way to the contribution collection authorities. In addition, it is not incumbent on a customer of a self-employed individual to inquire whether contributions are required from that individual. They will not be required from a company or other legal person in a similar position.

A policy consideration in demanding records from the self-employed for social security purposes is whether this approach is consistent with that followed for income tax purposes. For example, if the tax authorities have decided to dispense with bookkeeping for categories of the self-employed,[150] it is inappropriate to demand detailed records for social security purposes. Similarly, simplification of tax administration by adopting a high threshold for income tax purposes may be defeated if those below the threshold still have to meet onerous social security requirements.[151]

IV. International Aspects

A. What Limits Do Schemes Impose?

All countries find it necessary to impose limits on the jurisdiction of a compulsory social security scheme. A scheme requires two sets of limits: (1) those applying to individuals claiming benefit, and (2) those applying to persons liable to contribute. The limits may not be the same, but both normally require some continued economic activity, or at least some continued presence, in the territory of the state. The comparable direct tax rules are the residence of the employee or self-employed person and the residence of (or permanent establishment by) the employer within the state.[152] Labor relations principles do not follow this basis. For labor relations law purposes, the usual rule is that a state claims competence over employment if the place of employment is in the territory of the state. An employee who resides in one state and works (or whose work is based) in another state is treated on these principles as working in the state where the work is based. Income tax is generally charged where the worker lives, but may also be charged where the employment is carried out. Particularly in areas bordering two states or in states with many migrant workers, the tax and labor relations rules may frequently have different and conflicting effects on an employee.

[149]Some payments to the self-employed may be subject to withholding for income tax purposes. It may be possible to coordinate this with social security by allowing taxpayers to credit amounts withheld against their contribution obligation.

[150]For instance, by using presumptive income or by accepting estimates or very simple records.

[151]This is a reason why, as noted previously, the self-employed are only brought within voluntary social security schemes in some states.

[152]*See* vol. 2, ch. 18.

Claims to jurisdiction for social security schemes are usually based on labor relations principles because these schemes have been designed primarily by analogy with employment-based insurance. A scheme therefore aims to cover those who work at a relevant activity within the jurisdiction of the state. Although benefit questions and contribution questions can be decided separately, the rules determining contribution liability are normally coextensive with benefit entitlement. This is because at any one time entitlement to benefit and liability to contribute are normally regarded as coextensive. This follows from the fundamental idea that a benefit is funded by contributions rather than from general tax revenues. Unless a contributor stands to benefit from a scheme, why should there be a contribution? If there is no linkage, is not the contribution a disguised form of general taxation?[153]

If the state's social security provision is divided into several different schemes, it may be thought that the jurisdictional rules of schemes should differ. For example, a scheme providing benefits to families in respect of children could define entitlement to benefits by reference to whether a child is present or resident in the jurisdiction. The administrative complexity of having different jurisdictional limits to different funds should not be underestimated. If, as suggested above, there is one composite contribution payable by any contributor, there is a strong argument for having a common set of jurisdictional rules for liability to contribute. Further, if the scheme has common rules for the liability to pay contributions and has links between contributions and benefits, then there should also be common rules for benefits. A decision to widen the scope of benefit—for example, for family benefits—requires a change or removal of the linkage rules. Alternatively, it needs rules providing for arrangements, such as deemed contributions or contribution credits.

States in which contributions and benefits are linked may wish to ensure that a beneficiary can claim benefits only if the beneficiary is within the jurisdiction of the scheme, both as potential beneficiary and as former contributor. Unless the contributor has been within the scope of the scheme and has therefore actually contributed when potentially a contributor, there is no entitlement to benefit. This focuses attention on the continuing importance of the jurisdictional limits of a scheme. For example, if a contributory pension is payable only if an individual has contributed for 25 years, then the individual must, by definition, be within the jurisdictional test for that period to qualify.

[153]The situation is less clear when the scope of benefit entitlement is wider than contribution liability. If all contributors are entitled to benefit, and in addition other persons are also entitled to benefit, then the link exists alongside a form of cross-subsidy. The cross-subsidy may be justified on another basis, for example, to ensure that, on the ground of solidarity, the few children not covered by the general scheme are not deprived of support. Other general issues also arise when there are significant numbers of migrant workers who regularly work outside their "own" state, but whose families remain at home, or who are likely to return at several points during their working lives and on retirement.

The main policy and administrative constraints, therefore, argue for a common set of jurisdictional rules for both benefits and contributions and for all funds. The forms that these rules can take are discussed below, as are the problems of overlapping claims to jurisdiction by schemes in two or more countries.

B. What Jurisdictional Rules Are Used?

There is no required international set of provisions deciding the jurisdictional limits of social security schemes. Principles and practice have been developed through the activities of the ILO and ISSA, but these amount to best practice only. The adoption of an international approach to coordination of schemes has occurred only in the European Economic Area (EEA), as addressed in detail below. The steps taken in the EEA are important because they follow the forms of best practice accepted more generally. Aside possibly from nondiscrimination provisions, double taxation conventions do not apply to social security contributions.[154]

1. *Nationally Determined Limits*

Each scheme establishes its own jurisdictional coverage. For reasons set out previously, the rules for jurisdictional coverage may reflect the jurisdictional rules adopted by the state to define when an individual is employed within the jurisdiction of the state and when the employee's employer is within the state. For employees, the individual must be within the jurisdictional reach of the state for any rules applied by the state to operate realistically. This is because, without international agreements, the contribution authorities are unlikely to have either information or powers to enforce contribution liability beyond the territory covered by the national laws. Absent specific agreements, there are no information powers equivalent to those on which tax authorities rely.[155]

The practice of states is to set jurisdictional limits within these practical limits and without direct reference to any overlap with any other social security system. The key test is whether an employee is employed within the juris-

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[154]*See* OECD Model Tax Convention, *reprinted in* Baker, *supra* note 38, at Commentary on Article 2 (Taxes Covered), ¶ 3 (providing "[s]ocial security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received, shall not be regarded as [within the scope of the convention].") Although the "direct connection" is less apparent in some schemes than was the case when this wording was first adopted in 1963, the general proposition has not been questioned. However, article 24 of the OECD model, unlike the rest of the text, is not subject to article 2 and applies to all taxes. Otherwise, the provisions of the model and conventions that follow the model apply only to income taxes. The author is not aware of any practical application of, or specific argument for, any part of article 24 applying to social security taxes and contributions.

[155]The information exchange powers traditionally included in double taxation conventions do not apply to social security contributions. *See supra* note 154.

diction. For this to be shown to be the case, the employee's economic activities must occur, or primarily occur, within the territory covered by the scheme. The employer does not have to be within the jurisdiction of the state for this to occur. The issue of where an employment occurs is primarily a question of fact, but will also take the requirements of the contract of employment into account. Employment within the jurisdiction will require the presence of the employee in the jurisdiction and probably his or her residence. However, for the reasons noted previously, the employee may be regarded as resident for this purpose even though the employee is regarded as resident elsewhere for income tax purposes.[156]

2. *Specific Problems*

Most employments cause no jurisdictional problems, because there is no doubt about where the employment occurs. Doubts are likely to occur only in a few particular cases. One group is frontier workers, those who work in one country and live in another, crossing between the two frequently and perhaps daily. Another is migrant workers, those whose long-term homes are in one country but who are absent from those homes for limited periods for work reasons only. Others are transport workers (those whose jobs involve traveling on international transport) and government employees (e.g., diplomats and members of the armed forces on foreign tours of duty). Best practice has been to evolve special rules for each of these groups of employees as exceptions to the general jurisdictional rules. Separate provision is made for them in bilateral agreements. States may wish to restrict their claims to jurisdiction in this way by agreement. It is suggested that they should also provide for an underlying claim to jurisdiction over these groups of employees in case of doubt or in absence of an agreement.

3. *Migrant Workers*

It may be appropriate to follow a general practice regarding migrant workers, that is, those who come into the country to work or who leave it to work. Most countries have workers in both categories. Rules can be applied in the same way to both immigrants and emigrants. The simplest rule is to ignore immigration and emigration unless the change of country lasts more than a set time, for example, one or two calendar years. A time limit rule will exclude immigrants from liability to and entitlement from the state's schemes until they have been present in the state for the defined time. A year is likely to be the shortest practical time for a limit of this kind. One year may prove to be too short for many employees, and a period of two years, or even longer, is being adopted by agreement between countries or in individual cases. Because the

[156]Residence for income tax purposes will, in the case of disputed resident status, be determined under the rules of the relevant double taxation convention. This makes the home of the individual the residence rather than the place of work.

rule is exclusionary, it may be appropriate to allow the period to be extended when an employee is in the country temporarily, but for more than one year.

The time limit rule also applies to those leaving the country. Here, an employee remains within a scheme for, say, one year after leaving the country to work elsewhere. If the employee returns within the year, then the absence is ignored. The employee's liability to contribute and entitlement to benefit remain in place throughout the period, subject to any additional requirements, such as presence imposed on any claim to benefit.

4. *Rules for Employers*

Inclusion of an employer within the jurisdiction of a scheme is separate from inclusion of an employee of the employer. The presence of the employer needs to continue for the scheme to be applied. In practice, this may require a degree of presence similar to that of a permanent establishment for other tax purposes.[157] This requires a continuing presence of an economically active part of the business of the employer, normally a branch or an agency. The concept of permanent establishment may not be enough in itself. For example, the activities of the employee in question may amount to a permanent establishment of the employer, but with no other active presence in the state. To regard the employee's presence as establishing jurisdiction over the employer for social security purposes may be ineffective.

Special rules may be needed when employees are within the scope of a scheme but their employer is not. It may be necessary to provide that the employees are responsible for meeting the employer's obligations to pay the employees' contributions. It may be difficult to go further and impose the employer's contributions on that employee. Instead, if the employee is associated with any other employer in the state, that employer might be deemed to be the employee's employer for contribution purposes. This is an appropriate approach when the actual employer and the deemed employer are associated. It is particularly so when it is believed that the precise employment arrangements are designed to avoid contribution liability.

5. *Rules for the Self-Employed*

Separate jurisdictional rules are needed for the self-employed. As with employers, the analogy with the income tax rules is more valuable than for employees. The rules require that the individual conducting a profession have a

[157]Permanent establishment is defined in article 5 of the OECD and UN Model Tax Conventions in similar but not identical terms. OECD Model Tax Convention on Income and on Capital of 1992, art. 5, *reprinted in* Baker, *supra* note 38; UN Dep't of Int'l Economics & Social Affairs, UN Model Double Taxation Convention Between Developed and Developing Countries, art. 5, UN Doc. ST/ESA/102, UN Sales No. E.80.XVI.3 (1980). The same pattern of definition occurs in most individual tax conventions. A similar concept may also apply for other taxes. *See supra* ch. 6, sec. II(A).

fixed base. A permanent establishment is required for an individual trading directly. For income tax purposes, the rules decide how much, if any, of the profits of the individual are earned within the jurisdiction. For contribution liability, the key question is whether the individual is carrying out economic activities in his or her own name within the territory of the scheme to the extent that he or she should be within the scheme. The nationality of the individual will normally not be relevant to that decision, nor will the level of economic activities or their success (as measured by profitability). At the practical level, if the individual is not making any profits within the territory of the scheme, then no income-related contributions are due in any event.

Finally, a scheme may allow those who fall outside the obligatory contribution provisions to continue to contribute voluntarily. This may apply even if the individual is compelled to contribute to another scheme. The voluntary extension of a scheme in this way raises no issues of jurisdictional law.

C. Rules in the European Economic Area

The countries within the European Economic Area (the members of the European Union and some neighboring countries) have common rules to deal with international aspects of the jurisdictions of social security schemes. Although the common rules do not apply as such outside the EEA, the rules follow the recommended approach of the ILO. They provide a comprehensive approach to the problems of contribution liability of both employees and the self-employed when two or more countries are involved in determining liability. They must also influence the approach of candidate members of the EU or the EEA. In each case, they will also affect the policy choices of those countries in reaching bilateral agreement with other countries outside the EEA.

The main principles and rules for all EU member countries are laid down in Council Regulation 1408/71, as amended frequently since adoption.[158] Because the rules are contained in a regulation, its text applies directly in all members. It is also subject to official interpretation by the European Court of Justice. The Oporto Agreement establishing the European Economic Area applied these rules (including court decisions at the date of adoption) also to the other members of the EEA. Consequently, the regulation (and its supporting administrative regulation, 542/72)[159] applies throughout the 15 members of

[158]Regulation 1408/71 of June 14, 1971, on the Application of Social Security Schemes to Employed Persons and Their Families Moving within the Community, 1971(II) O.J. Special Edition (Dec. 1972), as amended. For the text and analysis, *see* David W. Williams, The National Insurance Contributions Handbook, FT Law and Tax at ch. A5, part D.1 (loose-leaf). For an account of the rules in the context of relevant EU law, *see* Stephen Weatherill & Paul Beaumont, EC Law at ch. 18 (1993).

[159]Council Regulation 574/72 of March 21, 1972, Fixing the Procedure for Implementing Regulation 1408/71 on the Application of Social Security Schemes to Employed Persons and Their Families Moving within the Community, 1972(i) O.J. Special Edition (Dec. 1972), as amended.

the EU (and some of their dependent territories), along with Norway and Iceland. The regulation covers all key issues relating to both contribution liability and benefit entitlement. The extensive rules about benefits are not discussed here, but provide the context of the rules relating to contribution liability. They allow states to ask each other for a transfer of contributions in appropriate cases.

The general rule, applicable to both employees and the self-employed, is that an individual is liable to contribute to the social security scheme of only one state at any one time. That state is the state in which he or she is employed, even if his or her residence is elsewhere and the employer is based elsewhere.[160] This is consistent, as noted previously, with the general principles of labor relations law. For this purpose, the individual is employed where he or she normally carries out the duties of the employment. If those duties are normally carried out in two or more countries, a tiebreaker rule applies. This allocates the individual to the country in which he or she is habitually resident, if some duties of the employment are carried out there.[161] The habitual residence test also applies to multiple employments. The liability of the employer follows that of the employee. The employer must comply with the employer's obligations under the laws of that country in which the employee is found to be employed.

The regulation provides six specific exceptions to the general rule, as follows:

(1) Employees leaving one state for another for a temporary assignment remain within their home state's schemes if the absence is a year or less. States have power to extend this period and are encouraged to do so for longer temporary assignments.

(2) If the undertaking of the employer itself crosses a frontier, the employment occurs in the state in which the employer is registered.

(3) Public servants and members of the armed forces of a state remain subject to the jurisdiction of that state.

(4) Diplomats and consular staff are entitled to the usual immunities from local jurisdiction and remain potentially subject to their home state jurisdictions. EU staff may elect to be covered either by the state where they work or by the state of nationality.

(5) International transport workers are treated as being within the jurisdiction of the state where they are based. However, if they are principally employed where they reside, then they fall within the jurisdiction of that state even if they are based elsewhere.

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[160]Regulation 1408/71, *supra* note 158, art. 13.

[161]*Id.* art. 14. The concept of habitual residence is one of EU law and is therefore subject to determination by the European Court of Justice. *See, e.g.*, Case 76/76, Di Paolo v. Office national de l'emploi, 1977 E.C.R. 315.

(6) Members of the merchant marine based on a ship registered in a member state are subject to the social security system of that state, unless an individual resides in a state and the employer is also registered in that state. In that case, the individual's state of residence has jurisdiction.[162]

Regulation 1408/71 also contains rules dealing with refugees and stateless persons. More generally, the regulation works within the framework of the fundamental and general principles of EU law. The two most important general rules are that states and public authorities may not discriminate within the EU either on grounds of nationality of any member state or on grounds of gender. These rules therefore apply alike to females and males and to all nationals of all member states of the EEA.

D. What Other Treaty Rules Exist?

Save for the EEA provisions, there is no general international agreement dealing with social security contribution liability. Some agreements make specific provision for particular cases. Specific agreements have been adopted to deal with international transport workers, with diplomats, consuls, and employees of international organizations, and with refugees and stateless persons. Apart from these provisions, agreement is usually by bilateral convention.[163]

The outline of the EU provisions also serves as an outline of the contribution provisions in the usual form of bilateral agreement. Within the scope of a bilateral agreement, the key principle is that the law of only one of the two states applies on a compulsory basis. The rules for deciding which of the two states has jurisdiction are usually similar to those outlined for the EEA and are based on the same approach. In practice, the time limit rule may have a period longer than one year; two years is increasingly common, and the United States is seeking a five-year period. The pattern of bilateral agreements is far from complete and falls far short of the otherwise similar patterns of double tax conventions or of trade and investment agreements. Within the European Union, bilateral agreements have been superseded by the Council Regulation in situations where the two texts overlap.

[162]Regulation 1408/71, *supra* note 158, arts. 13–17.

[163]Networks of bilateral agreements are growing slowly, but are far smaller than the equivalent networks of double tax conventions. For example, the United Kingdom, which has the largest network of double tax conventions (over 100), has one of the most extensive networks of social security conventions, covering reciprocal arrangements with the other 16 members of the EEA, and bilateral agreements relevant to contributions with the following other states: Barbados, Bermuda, Cyprus, Gibraltar, Israel, Jamaica, Malta, Mauritius, Philippines, Switzerland, Turkey, the United States, and Yugoslavia (plus British territories such as Northern Ireland and the Channel Isles where internal jurisdictional limits require agreements). It has a number of other social security agreements (e.g., with Australia), which have no provisions dealing with contributions. Poland and other countries with economies in transition are now negotiating these conventions. Poland has concluded several new conventions, including those with Belgium, France, and Germany.

V. Interaction of Income Tax and Social Security Schemes

A. General Principles

A funded social security system is designed to collect funds for disbursal within a closed group of people, usually those who contribute and their dependents. Income tax is an open system, taking funds from all those within the scope of the law and releasing them to be spent as general public expenditure. Any transfer between the funds collected by income tax and the funds collected in the social security system is therefore a transfer between two disparate groups. As a matter of general principle, it is assumed that these transfers should not happen except as a result of explicit policy decisions.

Interactions between income tax and social security are unavoidable. They can also be expensive in terms of funds forgone or transferred because of the large numbers involved in both schemes at any time. In practice, the rules of income tax systems and social security systems often interact in unintended ways. These interactions may result in transfers either from the open system to the closed system or the reverse. This section is designed to draw attention to these interactions so that policymakers and drafters have them in mind in considering the effects of their laws.

Interactions occur between income tax and contributions as competing methods of collecting funds. They also occur between income tax and benefit entitlement. The income tax treatment of private social security arrangements (e.g., occupational schemes and retirement benefit plans) must also be noted.

B. Interactions Between Contributions and Income Tax

The income tax and contributions systems are independent, even if both are collected by the same means. Without explicit provisions in either law, it may appear that the two systems therefore do not interact. In practice, they do.

1. *Rules for Deductibility*

The simplest case is that of income tax and contributions being collected under the same rules for defining liable income and for the same periods. This assumes that there are no differences in liability or timing between contribution liability and income tax liability. Each applies at a given percentage rate on the earnings. Will each be collected on the total amount of earnings or on the net amount after deduction of the other? This depends on the deduction rules for the two taxes.

There is no strong reason to grant employees a deduction for either of the payments against the other if they are both at reasonable overall levels. The total system is simpler and easier to administer if no deductions are allowed. It is also more transparent and has lower marginal rates. If a deduction for contributions is allowed against income tax, then the total income tax collected from most in-

dividuals is reduced. Making good that loss can only be achieved by raising either the rate of income tax or some other tax. It is better to ensure that neither system allows a deduction for the employee's payment to the other.[164]

For example, the rate of income tax in state *D* is 25 percent at the level of average earnings, and the employee's contribution is also 25 percent. If no deductions are allowed, the employee pays $50 on marginal earnings of $100. If state *D* allowed a deduction for social security contributions to be made against income tax, then, on earnings of $100, $25 is paid as contributions. The amount of earnings for income tax liability is $75. If state *D* wishes to collect $25 from the employee, the rate of income tax must be increased to 33 percent. The amount collected is the same, but the total marginal rate appears to be not 50 percent but 58 percent. If state *D* does not raise the rate to 33 percent, there may be hidden transfers between those paying contributions and other taxpayers. This is because, in effect, the income tax relief for the contributors has to be paid for elsewhere in the system. Some of it is therefore likely to be paid by noncontributors, who are essentially being asked indirectly to subsidize the contributions. What if state *D* adopted the converse rule? Instead of allowing a deduction for income tax, it allows it for contribution purposes. Here again the lost revenue would have to be made good. This would force up contribution rates because there is no other way of meeting the income loss. Further, unless care is taken in the way in which the income tax is relieved, the result could be unfair between different contributors. Those paying more income tax could pay lower contributions. Why should that be so?

2. *Measurement and Timing Issues*

The assumptions made in the above example are that the measurement and timing of the income tax and contribution liabilities on earnings are identical. That is frequently not the case. There may be timing differences in the collection procedures, and there may be differences in definition in the two laws. Each difference may cause a distortion between the two systems. For example, a particular benefit in kind is taxed to income tax but not to contributions.[165] The overall burden of tax on that benefit is therefore less than on other forms of income. It is therefore likely that employers will use that benefit when they can to pay employees. This will not affect the amount of income tax collected, but will

[164]Practice varies. In 1990, social security contributions could be fully deducted as expenses against income tax for employees in the following OECD members: Austria (subject to a ceiling), Belgium, Denmark, France, Germany (subject to a ceiling), Greece, Italy, Japan, Luxembourg, Spain, Switzerland, and Turkey. Partial deduction was allowed in Canada, Ireland, and Portugal. Deduction was not allowed in Finland, Iceland, the Netherlands, Norway, the United Kingdom, and the United States. *See* Messere, *supra* note 1, tbl. 10.7 at 272–73.

[165] For example, a deduction may be denied to the employer for the cost of certain fringe benefits provided to employees. Although not ideal, this may be more or less acceptable for income tax purposes (*see* vol. 2, ch. 14) but, as the text indicates, will create a problem for the contributions base. This illustrates the importance of thinking about the income tax and contributions together.

reduce total contributions. The effect is to cause a shortfall in contributions. This may require a rate rise that will, of course, not fall on those receiving the nonliable benefit in kind. What has happened is a shift of liabilities from some contributors to others caused by the mismatch of income tax and contribution rules. This problem is compounded if allowances are made in the income tax system for contribution payments (or the converse).

These complexities can be avoided for contributions by employees. They are harder to avoid for employer's contributions because the employer's contribution is usually regarded as a cost of labor. To prevent the employer from deducting the contribution is to increase the post-tax cost to the employer of that contribution compared with the employee's pay, which is difficult to justify in income tax terms. The result may be different if considered in terms of social security funding. For example, state *D* requires employers to pay an employer's contribution of 30 percent of earnings. This is deductible as an expense for business income tax purposes. One effect is that the employer recovers part of the cost of the contribution from general taxation. It may be argued that it is better, therefore, to deny employers a deduction for contributions, although this is not common practice.

3. *Treatment of Employer's Contributions*

Should the employer's contribution be treated as part of the earnings of the employee? The usual approach adopted by states is that it is not. If the employer's contribution is regarded as part of the earnings of the employee, the social security fund is not affected. However, an income tax problem arises. Income tax becomes due on the employer's contribution as well as on that of the employee. There may be no net gain to the system from this tax if, as a result, the rates of tax are lowered. There is an implicit tax privilege that benefits contributors compared with other taxpayers.

4. *Treatment of the Self-Employed*

If the self-employed are to be treated as receiving profits for income tax purposes, there is an argument that contributions should be deducted against profits for income tax purposes. Against that, comparison with the position of the employee might argue for nondeduction. These arguments will apply to the alternative treatments for the self-employed contribution. The most appropriate treatment may depend on whether the self-employed are paying a flat-rate contribution or an earnings-related one. It also depends, as noted above, on the total intended cost to the self-employed of their contributions.

C. Should Benefits Be Subject to Tax and Contributions?

The interaction between social security benefits and the income tax and contribution treatment of those benefits involves several complex issues.

1. *Making Benefits Subject to Contributions*

The first issue is whether benefits are subject to contribution liability. When benefits and contributions are related to the same fund, the simplest approach is to treat benefits as not subject to contributions. The fairness of this policy depends on how the rate of benefits compares with the income being replaced by the benefit. If, for example, the benefit fully replaces the income, the beneficiary will gain by having saved the contribution. The easiest approach to avoid overcompensation is to reduce the level of benefits by the amount saved. If the benefit only partially replaces the income, then exempting the benefit from contribution increases the net value of the benefit.

If the benefits and contributions do not relate to the same fund, broader policy issues arise. A failure to collect contributions amounts to preferential treatment of a benefit funded by other means. If the benefit is a safety net benefit, then contribution may not arise because the level of benefit is below the lower earnings level for contribution liability. That raises another policy question. How should the threshold for contribution liability relate to the level of social assistance benefits? Should the relationship be taken for each earnings period or be calculated to include a full year at a time? If the lower earnings level is below that of benefits received, then the state must decide if these benefits are to be subject to contribution liability in the same way as earnings. It may be argued that income-replacement benefits should be treated in this way. One reason for this is that exempting benefits from contribution liability may mean that the beneficiary accumulates no contribution record while receiving a benefit. Because of this, the beneficiary might appear to gain in the short term, but will lose in the long term.

2. *Notional Contributions*

A solution to the problem of imposing contributions on benefits is to use notional contributions. Benefits can be treated as subject to contributions, but the beneficiary is not expected to pay the contributions. Instead, he or she is granted a credit of a notional contribution. In this way, the beneficiary continues to accumulate a contribution record but does not have to pay for it directly. This raises another policy question. Who pays for the benefit receivable because of the credit? If the cost is met from within the general social security fund, then it amounts to a cross-subsidy, which is entirely appropriate if the benefits are paid from the fund. It may not be appropriate if the benefits are paid from other funds. Generally, it is desirable to subject benefits to either actual or notional contributions, both as a matter of administrative simplicity and to protect the long-term position of individual beneficiaries.

3. *Imposing Income Tax on Benefits*

With respect to the income tax treatment of benefits, there are two issues of principle. The first is whether benefit income should be liable to income

tax. The second is the legal nature of the benefit income if it is to be subject to income tax. It is not earnings, although it will normally be of an income nature. It may or may not be paid to replace earnings.

A broad-based income tax should, as a general rule, be imposed on benefits.[166] This is the simplest and least distortive approach and is consistent with the view that problems of social security and social assistance should be left to the social security system. It also prevents overcompensation of beneficiaries. If the income tax system has personal allowances or credits, the effect may be to remove those receiving minimum benefits from the charge to income tax. This depends, of course, on the level at which allowances or credits are set. If a personal allowance is set at a level above that of the safety net benefit entitlement of an individual, then no tax is payable unless the beneficiary has other sources of income. For instance, if a person is sick or unemployed for part of the year, but at work and earning during the rest of the year, then income tax is calculated on the total income of the individual for the year. The cumulative value of the benefits is therefore taxable. Imposing tax on benefits in this way prevents overcompensation. That will occur, for example, if a taxpayer receives sick pay free of tax in a year when income tax is payable on total earnings. In some cases, however, it may be appropriate to exclude benefits from income tax for administrative reasons, particularly when the value of benefits is low.

Assuming that benefits are to be taxed as income, how should they be taxed? Strictly, benefit income does not fall within the usual main forms of income. It may be most appropriate to treat it in the same way as earnings, although the beneficiary is unlikely to have any deductible expenditure in "earning" the income. This is because most forms of benefit are designed to replace income, particularly retirement and survivor's benefits, unemployment pay, and sickness benefits. Family benefits and benefits to the severely disabled are different but are most easily taxed in this way. For the sake of clarity, the income tax legislation should specifically authorize the taxation of taxable benefits.

These arguments suggest that benefits should be taxable and also subject to actual or notional contribution liability, although this policy may conflict with the policy toward private social security provision. Countries often give preferential treatment to private pension and insurance schemes. For example, there are three ways in which some countries may treat private retirement funds preferentially. First, the contributions of the employee (or self-employed

[166]National practice varies (as does treatment of different benefits within a state). In the OECD, most countries tax public pensions, while treatment is inconsistent with unemployment pay. Most countries do not tax invalidity payment, and almost all refrain from taxing family benefits. Some countries tax them in part, *e.g.*, USA IRC § 86. Canada and the Netherlands have few exemptions from tax, while Turkey has a considerable number. *See* Messere, *supra* note 1, tbl. 10.1, at 264–65.

individual) to the fund are deductible from earnings before the imposition of income tax. This can be argued to be a tax deferral, because the pension, when paid, is treated as taxable (and usually as deferred earnings).[167] Second, the employer's contribution is not treated as part of the employee's income.[168] Third, the income of the pension fund is itself exempt from tax.[169] A treatment of public social security funds inconsistent with this treatment of private funds creates a distortion between the state system and the private systems. The desirability of such a distortion is a policy issue. The hidden state support for retirement schemes in this income tax treatment, measured as tax forgone, is very expensive. The level of support is compounded if exemption is extended also to public social security schemes. The generosity of the tax treatment of private pensions is being reviewed in many places because of its expense, and it is suggested that there is little reason to increase the problem by any extension to the public sector.

D. Implicit Tax Rates on Benefit Programs

The complex patterns of interaction of contributions, income tax, and benefits rules can cause hidden traps in the general system of tax and support.[170] Two forms of trap may exist. The first is the poverty trap. This is the situation where an individual is trapped in poverty because he or she is unable to increase his or her net earnings through extra effort. Linked with this is the unemployment trap. This happens when an individual is unable to obtain a

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[167]This is common, but not universal practice. *Id.* at 168. Instead, in some states the pensions are not taxed (e.g., Turkey). A problem arises when the contributions are made to a pension scheme based in one state by a contributor liable to income tax in another state. In such cases, the tax authorities often refuse to recognize the contribution as deductible. The European Court of Justice, in Case C-80/94, Wielockz v. Inspecteur der Directe Belastingen, 1995 Simons Tax Cases 876, ruled that in some cases this could amount to unlawful discrimination under EU law.

[168]This is national practice throughout the OECD. *See* Messere, *supra* note 1, tbl. 10.1, at 264–65.

[169]National practice is not consistent.

[170]The terminology used in this section is derived from English public welfare economics literature. An early account is A.R. Prest, Social Benefits and Tax Rates (1970). An excellent series of essays on the topic based on a seminar bringing together officials and commentators is in Taxation and Social Policy (Cedric Sandford, et al., eds., 1980). The term "poverty trap" is sometimes used as a generic term to cover all forms of effect of the kinds described here. The reference to trap indicates a value judgment. The adoption of the convenient phraseology of that literature in this account is not meant to imply an adoption of those value judgments by the author. A neutral description of the trapping effect is that the interaction of each of the separate rates and thresholds for taxes, social security contributions and benefits, and social welfare receipts affecting an individual with little or no earned income produces a net negative marginal increase of total income to, or benefit for, that individual from all sources when adjustments are made to all receipts and deductions to take account of a unit of increase of earnings of the individual (poverty trap) or for a unit of replacement of benefit or other income with earnings (unemployment trap).

job that pays enough to make the claimant better off than receiving benefits. Both these effects deter individuals from seeking to improve their position and can be argued to trap them into receiving benefits. The argument is that the individual has no incentive to do anything other than continue to receive benefits. Other policies are also involved. Income tax is often regarded as a progressive tax. The tax system may also be regarded as partly designed to redistribute income. Poverty and unemployment traps distort the rate structure of the tax system as a whole and cause redistribution from the wrong individuals.

For example, state F has a progressive income tax. The lowest rate of income tax is 15 percent. It has a contributory social security system, with a set rate of contribution, the current employee's rate being 20 percent. It provides benefits in two ways. First, the social security fund provides a replacement income for the sick and the unemployed. Second, the state finances a rent benefit that meets the rent of those whose income is below the state poverty level. Those with incomes above that level receive no benefit.

Ben is currently unemployed. Ben receives $150 a week benefit from the state fund, and has the rent of $100 paid by the rent benefit. The state benefit of $150, and the rent benefit, are both free of income tax and contributions. To replace current benefits, Ben must earn enough so that, after deduction of income tax at 15 percent and contribution liability at 20 percent, the amount left is at least $250. Ignoring any contribution thresholds and income tax allowances, the minimum replacement income Ben needs is $392. To escape from the unemployment trap, Ben must therefore increase income from the $100 paid in cash by $292. Can that be done? Unless Ben earns more than $392, there is no point in his seeking work. Ben is caught in the unemployment trap.

Por has a part-time job because of the need to look after her two young children. Por's total income is below the state poverty level for a parent and two children. Consequently, Por receives the rent benefit, which is worth $150. Por has just been asked to work one more day a week, which will earn her $50 more. However, Por notes that this extra $50 will take her earnings over the state poverty level. She will therefore lose the state rent benefit and will not receive the full $50 because of income tax and contribution liability. At present rates, Por will receive only $33 of the $50. The extra day's work will therefore leave Por $117 a week worse off. Por refuses to work the extra day. Por is caught in the poverty trap.

E. Can High Implicit Tax Rates Be Avoided?

Can these traps be avoided? The examples given are deliberately very simple. In practice, examples are often considerably more complex. However, a benefit like the rent benefit in the example always creates a trap for those who cannot afford to lose the benefit by increasing their earnings. One

answer is for the allowance to be tapered. The allowance could be granted as a maximum of $150, with lower benefits to those with earnings in the "trap" area.

Suppose that the rent benefit had a "taper" of 70 percent. That is, for each $100 over the poverty level a beneficiary earns, $70 of the benefit is lost. This would still trap Por. Por pays income tax of 15 percent and contributions of 20 percent on the extra earnings, and loses 70 percent of the rent benefit under the taper rule. This amounts to a composite tax rate of 105 percent. It is not worth paying. Ben may be assisted. Tapering lowers the sum Ben must earn to improve his total income. If the taper were 60 percent and not 70 percent, then Por would gain by taking the extra work, although not by very much. Alternatively, the taper could be based on Por's income after deduction of income tax and contributions. The taper would then be 70 percent of the net increase in earnings, not of the full increase. Of course, a taper in either form also means that benefit must be paid to those above the poverty level. This may have a considerable cost. The income tax and contribution rates may also be tapered. The allowances may also be set so that they cut the trap effect on low earners. Removal of any threshold for social security contributions will further dampen the effect of changes. Support to low earners from the income tax system could be given through credits rather than through allowances, thereby changing the effect of an increase in earnings. Sometimes traps may be made less significant by removing a tax exemption, but increasing the underlying level of benefit so that the most deserving beneficiaries do not lose. Further up the income scale, the value of the benefit will decrease because of the tax. At the lower end, there is no net cost or benefit to the state.

How can traps like this be avoided? The most important issue is to ensure that all tax, contribution, and benefit provisions are examined to ensure that trapping effects are identified and, if possible, minimized. Sometimes this can be done through the way a benefit is worked, rather than through a simple increase in value. For example, a taper based on net income rather than gross income keeps the total effective tax rate from exceeding 100 percent. This shows that a solution to a trap may lie in the way a benefit is paid rather than the way it is taxed or made subject to contribution liability. It may be that the nature of the benefit has to be changed. Alternatively, it may help to pay a larger benefit that is taxable rather than a smaller benefit that is exempt from tax, so that the beneficiary receives the same amount, but the distortions are avoided. There is no simple solution.[171]

[171]The discussion under this head is based on the U.K. experience, in which the rent benefit (called housing benefit) and the help for poor families (known as family credit) are tapered in the way illustrated. This has reduced the highest implicit tax rates in the system to below 100 percent, but still leaves them far higher than the highest express income tax rate (40 percent). It is still widely regarded as unsatisfactory.

VI. Conclusion

The issues outlined in this chapter are receiving considerably more attention than in the past, largely for demographic reasons—the adverse shift in most countries in the dependency ratio of those receiving state benefits compared with those paying for them. This has forced schemes to increase contributory funding and to look for more effective ways of raising funds. The discussion shows that there is no clear consensus of how this should be done. Important issues are clearly regarded as based on tradition and history to a greater extent than with other taxes. Nonetheless, there is a need in many countries to address the issues raised in this chapter and to seek best practices both in the forms of contribution liabilities adopted and in the methods by which they are collected and enforced.

12

Presumptive Taxation

Victor Thuronyi

> Acetylene, Achievement awards, Acts of God, Affidavits, Age 55 or over, Age 65 or over, Agricultural irrigation projects, Agricultural labor, Aircraft, Air force, Alaska, Alcohol fuel credit, Aliens, Alimony and separate maintenance payments, Alternative minimum tax, Ambulances, Ammonia, Amortization, Amusement expenses, Anti-cruelty organizations, Apostolic associations, Apothecaries, Aquatic resources trust fund, Arbitrage bonds, . . .
>
> —*Research Institute of America Index to Internal Revenue Code*

I. General Concepts

Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts.[1] The term "presumptive" is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method. As discussed below, this presumption may or may not be rebuttable. The concept covers a wide variety of alternative means of determining the tax base, ranging from methods of reconstructing income based on administrative practice, which can be rebutted by the taxpayer, to true minimum taxes with tax bases specified in legislation.[2]

Note: This chapter has benefited from comments by Bertil Wiman, Rebecca Rudnick, Emilio Romano, Michael Engelschalk, Günther Taube, and Zühtü Yücelik, and research assistance by Jae So.

[1] A useful description is provided by Ahmad & Stern: "The term presumptive taxation covers a number of procedures under which the 'desired' base for taxation (direct or indirect) is not itself measured but is inferred from some simple indicators which are more easily measured than the base itself." Ehtisham Ahmad & Nicholas Stern, The Theory and Practice of Tax Reform in Developing Countries 276 (1991).

[2] For further discussion and analysis of presumptive taxation, *see* Indira Rajamaran, *Presumptive Direct Taxation: Lessons from Experience in Developing Countries*, Economic and Political Weekly (forthcoming); Arye Lapidoth, The Use of Estimation for the Assessment of Taxable Business Income (1977); Kenan Bulutoglu, *Presumptive Taxation, in* Tax Policy Handbook 258 (Parthasarathi Shome ed., 1995); Russell Krelove & Janet Stotsky, *Asset and Wealth Taxes, in id.* 181; Vito Tanzi & Milka Casanegra de Jantscher, *Presumptive Income Taxation: Administrative, Efficiency, and Equity Aspects* (IMF Working Paper, 1987) (see also sources cited in these works).

This concept does not cover all instances of the use of legal presumptions in taxation. More generally, a presumption can be said to be involved anytime a mechanical definition is used in place of a more open-ended rule based on the facts and circumstances of each case. The focus in this chapter is the use of a presumption to supplant the entire tax base, or an entire category of taxable income.

Presumptive techniques may be employed for a variety of reasons.[3] One is simplification, particularly in relation to the compliance burden on taxpayers with very low turnover (and the corresponding administrative burden of auditing such taxpayers). A second is to combat tax avoidance or evasion (which works only if the indicators on which the presumption is based are more difficult to hide than those forming the basis for accounting records). Third, by providing objective indicators for tax assessment, presumptive methods may lead to a more equitable distribution of the tax burden, when normal accounts-based methods are unreliable because of problems of taxpayer compliance or administrative corruption. Fourth, rebuttable presumptions can encourage taxpayers to keep proper accounts, because they subject taxpayers to a possibly higher tax burden in the absence of such accounts. Fifth, presumptions of the exclusive type (see below) can be considered desirable because of their incentive effects—a taxpayer who earns more income will not have to pay more tax. Finally, presumptions that serve as minimum taxes may be justified by a combination of reasons (revenue need, fairness concerns, and political or technical difficulty in addressing certain problems directly as opposed to doing so through a minimum tax).

This chapter deals with certain minimum taxes but does not discuss minimum taxes in general. Some minimum taxes are accounts-based taxes; they involve the use of different accounting methods from regular tax or they may involve the denial of certain deductions. These types of minimum taxes, along with the general concept of minimum taxation, are beyond the scope of this chapter.

Presumptive taxation can be used for any tax that is normally based on accounting records—income tax, turnover tax, and value-added tax (VAT) or sales tax—although it is most commonly used for the income tax. A number of different types of presumptive methods exist in different countries. The discussion below first considers some general characteristics of presumptive methods and then discusses particular cases. It is apparent from this discussion that different types of presumptive methods can have quite different incentive effects, revenue effects, distributional consequences, levels of complexity, and legal and administrative implications. This makes it dangerous to generalize about presumptive taxation.

The extent to which presumptive taxes are used varies greatly from country to country. Some countries (e.g., the United States) employ almost no pre-

[3] *See* Lapidoth, *supra* note 2, at 25.

sumptive taxation,[4] while others (e.g., France[5]) use presumptive taxes extensively.

Possible legal constraints on the adoption of presumptive methods should be considered in drafting legislation for their application, including constitutional constraints, such as equality before the law and a prohibition on confiscation of property.[6] They might also include obligations under international agreements. For example, some double tax treaties may prohibit taxing a nonresident on a presumptive basis without allowing the taxpayer to prove his or her actual income and be taxed accordingly.[7]

The use of withholding taxes is sometimes discussed together with presumptive techniques. Withholding taxes can also achieve the effect of taxation based on an alternative simplified base. Withholding is commonly used for the income tax and is usually based on the gross amount of a payment. Withholding can also be imposed on other bases, for example, on the amount of imported goods, with a credit allowed against income tax. The legal nature of withholding taxes is normally not the same as that of presumptions, because taxpayers normally have the right to file a return and receive a refund of excess amounts withheld. Therefore, although there is some commonality between withholding and presumptive techniques, the former is not considered in this chapter. If taxpayers are not given the right to claim a refund, then the withholding tax is in effect a minimum tax collected by withholding, which does not differ conceptually from other minimum taxes.

II. Legal Characteristics of Presumptive Methods

A. Rebuttable vs. Irrebuttable

Presumptive methods can be rebuttable or irrebuttable. Rebuttable methods include administrative approaches to reconstructing the taxpayer's income, and may or may not be specifically described in the statute. If the

[4]The main exception being rebuttable methods used as an alternative means of assessment. *See infra* sec. II(A). The United States has for about 30 years used minimum taxes involving calculation of the tax base according to accounting methods different from those used for the regular tax. As mentioned, this type of accounts-based minimum tax is beyond the scope of this chapter.

[5]In France, the importance of presumptive taxation is on the decline, compared with a few decades ago. *See infra* sec. III(D)(2).

[6]*See supra* ch. 2, sec. II; *infra* note 40.

[7]*See* OECD Model Convention art. 7(1), *reprinted in* Klaus Vogel, Double Taxation Conventions 308 (1991); UN Model Convention art. 7(1), *reprinted in id.*, at 309; U.S. Model Convention 7(1), *reprinted in id.* These provisions allow taxation of only the profits that are attributable to a permanent establishment. Imposition of a presumptive tax might result in a tax even where there are no such profits, and might therefore violate the treaty, if the presumptive tax is a tax covered by the treaty.

taxpayer disagrees with the result reached, the taxpayer can appeal by proving that his or her actual income, calculated under the normal tax accounting rules, was less than that calculated under the presumptive method.

By contrast, irrebuttable presumptive assessments should be specified in the statute or in delegated legislation. Because they are legally binding, they must be defined precisely.

Rebuttable presumptive assessments are a universal feature of tax assessment procedure, required in order to deal with cases where taxpayers either do not fully disclose their financial situations on their returns or fail to file a return. In these cases, the law normally authorizes the tax authority to use indirect methods to determine the taxpayer's income, based perhaps on arbitrary criteria or on whatever data are available. Because presumptive assessment is intended as a means of ascertaining the taxpayer's income in the face of inadequate data, the taxpayer should be allowed to present better data to refute the determination of the tax authorities. This type of presumptive assessment therefore does not represent a fundamental departure from the normal rules for determining tax liability, but is a fallback when these rules do not work because of noncompliance by the taxpayer.

The *forfait* applicable in France[8] is a hybrid between rebuttable and irrebuttable methods. It is rebuttable in the sense that the taxpayer may elect to use the normal accounting rules instead of the *forfait*. Under the *forfait*, the determination of income is a matter of negotiation between the taxpayer and the tax inspector. However, once it is agreed on for the specified period of two years, it applies automatically regardless of the taxpayer's actual income for the period.

B. Minimum Tax vs. Exclusive

Irrebuttable presumptions can be divided into two types: minimum tax, where tax liability is no less than that determined under the presumptive rules, and exclusive, where tax liability is determined under the presumption alone, even if the regular rules might lead to a higher liability. An example of the latter would be a tax on agricultural income based on the value of the land, with no reference to actual crop experience for the year.

The incentive effects of exclusive presumptions differ substantially from those of the income tax. Exclusive presumptions create no disincentive to earn income. Rather, the incentive effects of the tax will depend on the factors used to determine presumptive income. These incentive effects will be minimal when the factors on which the presumption is based are in inelastic supply, land being the quintessential case. An exclusive presumption is in fact not an income tax at all, but is a tax on whatever is used to determine the presumption. Depending on the factors used, it may be more like a tax on potential in-

[8]*See infra* sec. III(D)(2).

come (if based on factors of production) or on consumption (if based on lifestyle).

Exclusive presumptions are administratively simpler than presumptions of the minimum tax type, because minimum tax presumptions require two tax bases to be calculated and compared.

While exclusive presumptions have the advantage of simplicity and minimal disincentive effects, they suffer from a lack of equity. Taxpayers with substantially differing amounts of actual income must pay the same amount of tax if their presumptive tax base is the same.

C. Mechanical vs. Discretionary

Presumptive methods can also be distinguished according to the degree of discretion that they allow tax officials. Some presumptive methods are quite mechanical, allowing no discretion, for example, methods based on a percentage of gross receipts or of a firm's assets. Other methods, such as the net worth method,[9] involve a large degree of discretion for the agent applying them.

Methods involving a large measure of discretion will generally be rebuttable, because otherwise too much power, and potential for arbitrary action, would be given to the revenue authorities. Mechanical methods may or may not be rebuttable. In some cases, a method will be mechanical (and irrebuttable) if applied, but the tax authorities have discretion as to whether to apply it. This was the case, for example, with the presumption based on signs of lifestyle in France, which was irrebuttable (although it has subsequently been changed to a rebuttable presumption). Tax agents were directed not to apply the presumption when its application would be harsh, although they were not legally bound to refrain from applying the method.[10] A taxpayer could perhaps in rare cases successfully argue that being subjected to the presumption constituted an abuse of discretion if the presumption were being applied under circumstances where the tax authorities were instructed generally not to apply it.

As in other areas of tax law, the choice between mechanical and discretionary rules will involve factors such as the following: the potential for corruption in the case of discretionary rules, the potential harshness of mechanical rules, the reduced administrative resources needed to apply mechanical rules, and the potential for expressing the particular matter as a mechanical rule.

D. Scope of Application

Presumptive taxation is commonly used in the context of the income tax. Some presumptive methods completely supplant the income tax for particular

[9]*See infra* sec. III(A)(2).

[10]*See infra* sec. III(E).

taxpayers. In other cases, the presumptive method may determine a portion of the tax base, for example, the income from a particular business or agricultural activity. Presumptions are also used for taxes other than the income tax. Thus, the *forfait* methods for small traders often cover both income tax and VAT liability.[11] Presumptive methods have also been used for the excise tax.[12]

E. Taxpayers Targeted

Presumptive methods can be distinguished according to the types of taxpayers who are targeted. In general terms, three groups of taxpayers have been the source of problems against which presumptive methods have been directed. The most common problem is noncompliance by small businesses and professionals. A second problem is noncompliance by individuals (this may be related to the first, but the focus is on amounts that individuals have taken out of their businesses or received from other sources and used for consumption). A third group of targeted taxpayers is businesses as a whole, including large companies.

The appropriate design of a presumption will depend on the particular problems it is seeking to address. Therefore, before a particular presumptive method can be recommended or designed for a specific country, it is necessary to ascertain what types of taxpayers are giving rise to problems under the normal rules for determining the tax base and the nature of those problems. Presumptive taxation may or may not be an appropriate solution. For example, if a particular group of taxpayers is unable to comply with the tax system, consideration should be given to whether it is possible to remove that group from the tax system altogether.

III. Particular Presumptive Methods

A. Reconstruction of Income

1. *In General*

If the taxpayer has failed to file a return or has substantially understated his or her income, and the transactions giving rise to income cannot be traced, the tax authorities are usually authorized to assess income on their best judgment. This could involve use of a method such as net worth, or bank deposits, or some other approach that has a factual basis for the particular case. As long as the assessment is based on reasonable facts, it will be upheld, subject to the

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[11] *See* FRA CGI arts. 50, 265; ESP IVA art. 122 *et seq.*; VAT Regulations arts. 34–42 (ESP), *reprinted in* 2 Leyes Tributarias: Legislación Básica 1298–1305 (5th ed. 1992).

[12] *See* Sijbren Cnossen, Excise Systems: A Global Study of the Selective Taxation of Goods and Services 74–83 (1977).

taxpayer's right to come forward with proper evidence of income; no specific methodology is prescribed.[13]

The legal authority to make best judgment assessments is usually provided in general terms in the statute. In some countries, there are no particular thresholds for use of indirect methods. Thus, in Israel, the assessing officer has the power to "determine to the best of his judgment the amount of the person's chargeable income and assess him accordingly, if he has reasonable grounds for believing that the return is not correct."[14] In the United States, the Internal Revenue Code gives the IRS general authority to make assessments and determine deficiencies in tax;[15] no distinction is drawn in the statute between direct and indirect methods of determining a deficiency.[16] The permissible bases for proving a deficiency using indirect methods have been elaborated in judicial decisions.[17]

In other countries, indirect methods may be applied only under certain circumstances specified in the statute. In India, the statute requires best judgment assessments when the taxpayer has failed to file a return or to produce information, and authorizes such assessments when the taxpayer's accounts are incorrect or incomplete or when no method of accounting has been regularly employed by the taxpayer.[18] In Argentina, the *determinación de oficio* applies whenever the taxpayer has failed to file a return or when the return is inadequate.[19] In France, the procedures for *imposition d'office* are set forth in the *Livre des procédures fiscales*.[20] This procedure applies when the taxpayer has failed to file a return, has failed to furnish information to the tax authorities upon re-

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[13]"The Officer is to make an assessment to the best of his judgment against a person who is in default as regards supplying information. He must not act dishonestly or vindictively or capriciously, because he must exercise judgment in the matter. He must make what he honestly believes to be a fair estimate of the proper figure of assessment, and for this purpose he must, their Lordships think, be able to take into consideration local knowledge and repute in regard to the assessee's circumstances, and his own knowledge of previous returns by and assessments of the assessee, and all other matters which he thinks will assist him in arriving at a fair and proper estimate; and though there must necessarily be guess-work in the matter, it must be honest guess-work. In that sense, too, the assessment must be to some extent arbitrary." 1 N.A. Palkhivala & B.A. Palkhivala, Kanga and Palkhivala's The Law and Practice of Income Tax 1154 (1990) (quoting CIT v. Laxminarain Badridas, 5 ITR 170, 180 (1937)).

[14]ISR IT § 145(2)(b).

[15]*See* USA IRC §§ 6201, 6204, 6212.

[16]*See* Holland v. United States, 348 U.S. 121, 131–32 (1954) (use of net worth method not restricted to cases where the taxpayer kept no books).

[17]*See id.* at 124–29 (discussing matters where exercise of care is needed in applying the net worth method in criminal prosecutions for tax evasion).

[18]*See* IND IT §§ 144, 145(2).

[19]*See* ARG APFI art. 23.

[20]*See* Livre des procédures fiscales, arts. L. 65–L. 76A. *See generally La Taxation d'office à l'impôt sur le revenu*, 31 Annales de la Faculté de Droit et des Sciences Politiques et de l'Institut de Recherches Juridiques, Politiques et Sociales de Strasbourg (1980) (*Taxation d'office* is a form of *imposition d'office*.)

quest, or, in the case of a nonresident taxpayer, has failed to designate a representative in France.

The drafter of statutory authority for indirect methods must make a basic choice between a general authority (which provides the greatest flexibility to the tax administration) and a restricted authority (which may provide procedural defenses to the taxpayer). If a restricted authority is chosen, it should be drafted in such a way as to minimize disputes between the taxpayer and tax authorities as to its application.

Under normal circumstances, a tax administration can afford to process relatively few cases on the basis of indirect methods of proof because of their labor intensity. However, the threat of a best judgment assessment can be used against nonfilers (or those who file obviously inadequate returns): an assessment can be made on a very crude basis, not to develop an accurate determination of income, but to induce the taxpayer to come forward with a complete return. This power has been misused in some countries whose tax administrations rely too heavily on the best judgment assessment, with a consequent possibility of corruption. To prevent this type of problem, supervisors in the tax authority should monitor the use of best judgment assessments.

2. *Net Worth Method*

In the absence of substantial information about the taxpayer's actual income, a commonly employed method is to estimate income by determining the change in the taxpayer's net worth over the year and adding to this amount the estimated personal consumption expenses, determined by examining the taxpayer's lifestyle.[21] In principle, any use of funds other than those that would be reflected in increased net worth should be included as personal consumption expenses for this purpose (e.g., gifts made to others). As a matter of income tax theory, this approach cannot be faulted, since income can be defined as consumption plus change in net worth.[22] The difficulty is typically the lack of evidence and the consequent need to make rather imprecise estimates. Courts have nevertheless allowed this method to be used on the basis that the taxpayer brought it on him- or herself by failing to furnish particulars of the taxpayer's income.

The net worth method is often not based on specific statutory authority, but rests on the broad power of the tax administration to make best judgment assessments.[23] Some countries have codified the net worth method, but sometimes with insufficient attention to the details of its operation. For example, in Colombia a rebuttable presumption stipulates that income is no less than

[21] *See* Annotation, *Use of Net Worth Method in Prosecution for Evasion of Federal Income Tax*, 99 L. Ed. 167 (1955).

[22] *See* Henry Simons, Personal Income Taxation 50 (1938). *See also* Victor Thuronyi, *The Concept of Income*, 46 Tax Law Review 45 (1990).

[23] *See* Lapidoth, *supra* note 2, at 110.

the increase in net worth, reduced by items of exempt income. However, this formula fails to take into account consumption, so that it results in a substantial understatement of income where, as is usual, most of the taxpayer's income is consumed.[24] In India, the Income Tax Act specifically states that if, in any financial year, a taxpayer is found to be the owner of money, cash credits, property, or other investments and cannot explain their source, then their value may be assessed as income for that financial year.[25]

In terms of the typology set forth above, the net worth method is usually rebuttable; it replaces the entire tax base; and it involves a limited but still substantial degree of discretion, in that the reconstruction of net worth at the beginning and end of the year, and of consumption expenses during the year, requires the exercise of judgment. The taxpayer is normally allowed to rebut the results under the net worth method, either by furnishing full details and evidence of actual receipts or by showing that the consumption plus increase in net worth was financed by nontaxable receipts (e.g., gifts, bequests, or, in a country with a territorial system, foreign-source income).

The net worth method is labor intensive, requires sophisticated auditors, and is therefore not suited for mass application. The elements on which it rests are often difficult to apply, requiring information on the taxpayer's wealth holdings and consumption expenditures in a situation where by hypothesis the taxpayer has not been cooperative in furnishing information. Rather, it can be used to go after a few taxpayers who have totally failed to comply with their tax obligations. It cannot be relied on as a significant revenue source in itself, and is better thought of as part of the arsenal of tools that can be used to induce compliance. These observations apply with equal force to the bank deposit method and the expenditures method, described below.

3. *Bank Deposit Method*

Another method auditors use to determine income in the absence of an adequate declaration is to secure records of deposits into the taxpayer's bank accounts (in both foreign and domestic banks) and to presume, unless the taxpayer can show the contrary, that the deposits constitute income. Depending on the taxpayer's financial and business practices, this can, of course, lead to either a grossly exaggerated or a grossly understated estimate of net income.[26] Nevertheless, courts have allowed this method of estimating income, again on

[24]*See* Charles E. McLure, Jr. et al., The Taxation of Income from Business and Capital in Colombia 47, 144–45 (1990).

[25]*See* IND IT §§ 68–69B; Palkhivala & Palkhivala, *supra* note 13, at 863–69; Lapidoth, *supra* note 2, at 114–17.

[26]A substantial underestimate results in cases where most of the taxpayer's income is received in cash and never finds its way into the taxpayer's bank account. An overestimate results where the deposits reflect gross receipts or transfers from other accounts.

the principle that if the taxpayer considers it unfair, he or she can furnish details of actual income.[27]

The effectiveness of this method obviously depends on the state of development of a country's financial institutions. In countries where most amounts are transferred in cash, it is not likely to be very helpful.

4. *Expenditures Method*

When evidence of the taxpayer's net worth is not available, income can be presumed on the basis of total cash expenditures. In countries where methods of indirect proof of income are not codified, this can be one possible approach under the authority to make best judgment assessments. It may be impossible to use the net worth method because evidence of net worth is unavailable. In some countries, taxation on the basis of personal expenditures has been codified, in which case a difference in result can occur from the best judgment assessment in the sense that personal expenditures, instead of being an indirect method of proving taxable income, become a tax base in their own right in situations contemplated by the statute.[28] Previously in France, individuals could be taxed on the basis of their "open and notorious" personal expenditures,[29] but this method has now been repealed.[30] A similar rule has also been repealed in Germany.[31]

B. Percentage of Gross Receipts

The legislation of some countries[32] provides a minimum-tax type of presumption, whereby the taxable income of a business can be no less than a specified percentage of the gross receipts of the business. For businesses paying tax on this basis, the tax has the same economic effects as a turnover tax, rather than an income tax, although the situation is more complicated when a company alternates between paying tax on gross receipts and paying tax on income.

It is difficult to see the attractiveness of this type of tax beyond the facts that it is relatively easy to administer and raises revenue. These characteristics are shared by sales taxes. If a sales tax is desired, it should be adopted explicitly, rather than in the guise of a minimum income tax. As a sales tax, the gross receipts tax is defective, because it involves substantial cascading.

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[27]*See* Michael I. Saltzman, IRS Practice and Procedure ¶ 7A.02[1][d] (2nd ed. 1991).

[28]*See* Lapidoth, *supra* note 2, at 60–63.

[29]*See id.* at 61–63. *See* FRA CGI former art. 180, then LPF art. L 71.

[30]*See* Loi No. 86-1315 du 30 décembre 1986, art. 82-11.

[31]DEU EStG § 48. *See* International Program in Taxation, Harvard Law School, World Tax Series: Taxation in Germany 325–26 (1963).

[32]*E.g.*, SLE IT § 23; COL ET § 180, 188 (repealed as of 1990).

The cascading effect of the tax has two dimensions. First, when most firms are taxed on a gross receipts basis, rather than on income, the tax becomes like a sales tax and involves the familiar cascading problem of such a tax. Second, the degree of integration of a firm may determine whether the firm pays tax on a presumptive basis. For example, suppose that the statute provides that minimum taxable income is 5 percent of gross receipts. Firm *X* produces a product at a cost of $96 and sells it to firm *Y* for $100. In turn, *Y* incurs expenses of $10 and resells the product for $114. In this situation, *X*'s and *Y*'s profit of $4 each would be less than the statutory percentage, and each would instead pay tax on the presumptive basis. However, if the firms merged, producing at a cost of $106 and selling for $114, they would pay tax on the profit of $8, and the presumptive tax would not apply.

A further problem with this type of minimum tax is that there is no close correlation between a particular year's income and turnover.[33] Moreover, net income is likely to represent widely varying percentages of gross receipts depending on the industry concerned, the degree of integration of the particular enterprise, and the type of product or service provided (e.g., a boutique may require a higher profit margin to cover its costs than a high-volume sales operation). Using the same percentage for all companies will therefore be highly inaccurate as a means of approximating net income.

The problem can be addressed, as some countries have done, by classifying taxpayers according to their business and by specifying a profit percentage to be applied to gross receipts, based on industry studies for each type of business to be covered.[34] This kind of presumption can be applied as an exclusive way of taxing income, as a minimum tax, or as a *forfait*. This more sophisticated approach reduces the inaccuracy of the presumption, but makes it more complicated to apply, particularly to taxpayers whose operations cross industry lines. Moreover, to be accurate this method requires research into actual profit margins, an effort that involves significant resources and may be difficult to accomplish in conditions of general economic instability. Therefore, it would be more suitable for some countries than for others.

The receipts-based presumptive tax can also encounter enforcement problems and result in unevenness of application. If taxpayers fail to declare their gross receipts, they can avoid the presumption. So the basic audit problem of determining gross receipts is not addressed by this type of tax. Accordingly, it is not likely to be effective in raising revenue from the types of taxpayers whose gross receipts are difficult to ascertain, such as independent professionals, and is more likely to impinge on those taxpayers who cannot hide their gross receipts.

As with other minimum taxes, the apparent simplicity of the receipts-based minimum tax is undermined by the need to make complicated adjust-

[33]*See* McLure et al., *supra* note 24, at 144.
[34]*See infra* sec. III(D)(3).

ments for taxpayers who alternate between paying tax on a presumptive basis and paying the regular income tax.[35] If such adjustments are not made, then the presumptive regime can involve a disproportionally high tax liability for taxpayers whose income tends to fluctuate substantially from year to year.

In drafting rules for such a minimum tax, it is necessary to specify which taxpayers are subject to the tax and what items are included in gross receipts. For example, one could specify that gross receipts include all receipts of a business and that both individuals and corporations are subject to the tax. This requires determining what receipts are business receipts. Should items such as interest, dividends, and rents be treated as business receipts and, if so, under what circumstances? It may make sense to exclude such items from business receipts for purposes of the minimum tax, in part because the profit margin is likely to be higher than for other business receipts. It would be most accurate to compare the specified percentage of business receipts against taxable business income, and then to tax investment income separately. Under such an approach, expenses must be allocated among business and investment income, not always an easy exercise. On the other hand, if all receipts are lumped together, then it is easier to engage in tax planning to avoid the tax. For a taxpayer whose profit margin is low, so that it has to pay the gross receipts tax, the game would be to earn enough financial income (where the profit margin is higher), so as to bring the average profit margin up to the level specified by the gross receipts tax.

An alternative that some countries have adopted[36] is to make the gross receipts presumption rebuttable. Although this alternative takes care of many of the problems of the gross receipts tax, it also takes most of the teeth out of this type of minimum tax.

C. Percentage of Assets

Several countries, including Argentina, Colombia, Mexico, and Venezuela, have adopted minimum taxes based on a fixed percentage of the assets of a business.[37] In Bolivia, such a tax replaced for a time the corporate income tax; that is, it was an exclusive presumption.[38] The tax base varies from gross assets (Argentina) to net assets—assets minus debts (Colombia)—with the Mexican tax taking a middle position whereby certain debts are deductible. The economic rationale for the assets tax is that investors can expect ex ante to earn a specified average rate of return on their assets. Of course, such taxa-

[35]*See* McLure et al., *supra* note 24, at 142–43. *See also infra* sec. III(C)(6)(b).

[36]*E.g.*, SLE IT § 23(3).

[37]The assets tax came into effect in 1990 in Argentina, 1974 in Colombia, 1989 in Mexico, and 1993 in Venezuela.

[38]*See* BOL IRPE. The tax on presumed income was replaced by a tax on business profits at the end of 1994. *See* Gonzalo Ruiz Ballivián, *Bolivia Introduces General Profits Tax*, 11 Tax Notes Int'l 1087 (1995).

tion could be considered unfair because the ex post return will differ from what was expected. Moreover, the minimum asset tax can discourage risky investments under circumstances where it denies the taxpayer the benefits of carrying over the losses resulting from the investment.

To evaluate whether it makes sense to have an assets tax and how such a tax should be designed, it is necessary to establish the purpose that such a tax is to serve. An assets tax can be justified as a permanent part of the tax system only if it can help resolve problems with the administration of the income tax that are difficult to address directly.

For example, the assets tax might be useful as an indirect way of addressing transfer pricing problems. Suppose that the tax administration finds it difficult to police transfer pricing cases directly and that multinationals are using transfer pricing to seriously undercut the tax base. The assets tax allows the collection of revenue regardless of reported transfer prices. However, this strategy works only if the resident companies subject to the assets tax have substantial assets in the country. Often, the problem with transfer pricing cases is the existence of intangible values that are not included in the balance sheet of the domestic subsidiary. Moreover, the question can be raised whether the relatively narrow problem of transfer pricing warrants such a broad response.

In addition to transfer pricing problems, the income tax may suffer from generalized underreporting of income and other evasion. If so, the assets tax may help, the question being whether the same conditions that allow evasion of the income tax would also allow evasion of the assets tax. For example, if the basic problem is corruption of tax inspectors, it is unlikely that introducing an assets tax will correct the problem, because inspectors can be bribed in the same manner under both legislative schemes.

Finally, the assets tax may be used to address problems of timing in the income tax.[39] Under the general assumption that over the long term a holder of wealth would expect to earn at least the risk-free rate of return on that wealth, the assets tax is a reasonable proxy for ex ante economic income, while the accounting rules for the income tax may lead to deferral of that income. Despite its theoretical underpinnings, this argument has two principal flaws: (1) it leads to taxation of ex ante income, while fairness considerations call for taxing ex post income, and (2) it depends on a reliable valuation of the taxpayer's wealth. Moreover, this argument would justify a tax based on net assets, not on gross assets.

The specific design questions that come up for the assets tax will differ from case to case, but some common issues are highlighted in the following sections. The discussion is relatively more detailed than in the rest of the chapter, given the complexity of the drafting issues involved.

[39] *See* McLure et al., *supra* note 24, at 140.

1. Gross or Net Assets?

Perhaps the most critical question in designing the assets tax base is whether there is to be any deduction for debt. Argentina has provided no deduction for debt. In Mexico, debts to resident companies (other than financial institutions) are generally deductible and financial institutions are exempt from the assets tax.[40] The net worth tax in Colombia allows a full deduction for debt.

Because the assets tax serves as a backstop for the income tax, it makes sense to coordinate the rules for deducting interest between the two taxes. If thin capitalization is perceived as a problem under the income tax, the appropriate remedy is to fashion limitations on the deduction of interest under the income tax. Corresponding rules can apply for purposes of the assets tax. For example, there can be a concern that loans from related foreign persons are in the nature of equity rather than debt, or that certain loans are fraudulent. If these concerns justify denying a deduction for these loans under the assets tax, they would presumably also justify a denial of the deduction for interest on these loans for income tax purposes.

Mexico's approach in allowing a deduction for debts except those to financial institutions, and then exempting financial institutions from assets tax, maintains the aggregate assets tax base at a value equal to total assets in the corporate sector. The size of the total assets tax base is not too relevant, however, because many companies are in a position of paying income tax, rather

[40]Except for the tax on leased property and inventories. In a decision of Feb. 22, 1996, the Supreme Court of Justice of Mexico held the exemption of financial institutions from the assets tax to be unconstitutional. Article 31 of the Constitution provides that all are equal before the law. The court found that, in tax matters, the legislator can draw distinctions only if these are based on an objective and reasonable ground. The court found that there was no distinction between financial institutions and other companies that could justify exemption of the former. The dissent argued that an important purpose of the assets tax was to serve as a minimum tax for the income tax. Because financial institutions were under strict supervision of the financial authorities, their latitude to minimize their income tax liability was minimal. Therefore, the legislator could rationally exempt them from the assets tax. While this argument has some merit, the majority pointed out that financial supervision did not completely rule out tax avoidance on the part of financial institutions and moreover did not justify exemption from the tax, since the tax had a revenue-raising purpose beyond safeguarding the income tax. In my view, the Mexican court failed to adequately examine the operation of the assets tax as a whole. Exemption of financial institutions (coupled with nondeductibility of debt to such institutions) is a rational legislative approach that should pass muster under the principle of equality. The opinion illustrates that courts often have difficulty in dealing with matters of tax policy and further illustrates that it is easy to justify both sides of an argument about whether a distinction made for tax purposes can be justified under the principle of equality. If courts are willing to test tax laws against the principle of equality in a vigorous manner, many aspects of tax legislation could be overturned by the courts. The decision of the Mexican court on the assets tax shows that seriously misguided results can be reached in cases of this kind. One possible legislative defense against such an eventuality is to spell out in a preamble or in explanatory material the justification for any provisions that may be considered discriminatory.

than assets tax. Moreover, the Mexican rules can give rise to tax planning opportunities. A company that pays assets tax rather than income tax and that is indebted to a financial institution can instead borrow from a company that pays income tax, who would in turn borrow from the financial institution (the transaction would have no effect on the income tax liability of either company). Net lending from the banking sector would be the same. The debt of the assets tax payer would now be deductible. The lender's assets tax base would increase, but its tax liability would not, as long as it remained in a position of paying income tax rather than assets tax.

If it is decided to impose the assets tax on gross assets, then it would be necessary to provide an exemption for financial institutions, which would otherwise be subject to a huge tax burden.

2. *Who Is the Taxpayer?*

The specification of the taxpayer and the tax base should also be linked to the purpose of the tax. If the purpose of the assets tax is to serve as a minimum income tax for taxpayers with business income, then the taxpayers and assets within the scope of the tax should be specified accordingly.

For example, the Mexican tax applies to resident physical persons on all their assets used in a business, as well as to all the assets of resident juridical persons. It extends to assets wherever located (this is consistent with the income tax being based on worldwide income). The tax also applies to the assets of a nonresident's permanent establishment in Mexico.[41]

3. *Tax Rate*

If a tax on gross assets were applied in lieu of an income tax, setting the rate would be a relatively precise exercise, designed to capture the average rate of return on assets. When the tax is a minimum tax, however, there is a much greater scope for maneuver in setting the tax rate. The higher the rate, the larger the number of enterprises that will be subject to the minimum tax, as opposed to the regular tax. The tax rate is 2 percent in Argentina and Mexico and 1 percent in Venezuela.

4. *Tax Base*

Assuming that the assets tax serves as a minimum tax for business income, the tax base should include all assets used in the business.

[41]MEX ATL art. 1. The term "nonresidents" presumably encompasses both physical and juridical persons. Nonresidents without a permanent establishment (P.E.) are nevertheless subject to tax in Mexico on inventory to be processed in Mexico. *Id.* This provision is no doubt directed at companies who plan their affairs so as to avoid being treated as having a permanent establishment in Mexico. If they did have one, then its inventory would be subject to assets tax, whereas if they avoid P.E. status, no one would, absent this rule, have to pay assets tax with respect to this inventory.

A. Average Value vs. Opening or Closing Balance

A key issue is when the assets are to be valued. The simplest approach is to value the assets at the beginning or the end of the year. If this rule were adopted, however, taxpayers could engage in window dressing. That is, companies who are assets tax payers could shift assets for one day to companies who are income tax payers.[42] Moreover, either beginning-of-year or end-of-year valuation will lead to some inaccuracy if it is not representative of the value of income-generating assets over the course of the year.

Accordingly, the tax base in Mexico is the average value of assets. The use of average values leads to a more accurate application of the tax; if there were a substantial change in a firm's assets during the course of a year, it would be unfair to base the tax for the entire year on the opening asset value.

Valuing assets on the basis of average value leads to complexity, although the additional complexity involved is minimized to the extent that the same rules are used for the assets tax as for the income tax generally.

In Mexico, for example, financial assets are generally valued according to average monthly value (based on value at the beginning and end of the month). Financial assets expressed in terms of foreign currency are valued at the exchange rate prevailing at the beginning of each month. Fixed assets are valued as for income tax purposes, including an adjustment for inflation, and taking into account only a pro rata share of assets that are acquired or disposed of during the course of the year. Inventory is taken into account at the average of closing and opening inventory value for the taxable year.

B. Integration

Should the assets tax base include shares or other interests in legal persons that are themselves assets tax payers? To include such interests seems to be double counting, in that the underlying assets of a business would be counted twice (or more than twice if there are additional tiers of corporate ownership). Whether this is appropriate should be determined with reference to the corporate integration rules of the income tax. For example, under a system whereby intercorporate dividends are fully taxed, including corporate shares in the assets tax base would be consistent with the income tax treatment. By contrast, under a system where corporations obtain a full exclusion for dividends received for income tax purposes, shares in domestic corporations should also be excluded from the assets tax base. If there is only partial integration, then only a partial exclusion would be appropriate. In Argentina[43]

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[42]For example, a company with too many assets could sell some assets to an income tax payer. The sales proceeds could be used to pay off nondeductible bank debt. The transaction could then be reversed on the following day. Such a transaction might, of course, be subject to legal challenge under abuse-of-law or other antiavoidance rules. *See supra* ch. 2, sec. III.

[43]ARG IA art. 3(d).

and Mexico,[44] shares in domestic companies, that is, companies that are themselves subject to assets tax, are excluded from the shareholder's tax base.

C. LEASING

In the absence of special rules for leasing, taxpayers can avoid the assets tax by leasing property instead of purchasing it. The lessor could be a company that pays income tax rather than assets tax and that is therefore indifferent to the increase in its assets tax base resulting from the lease transaction. Assuming debt finance, the two options of leasing or buying property can be economically very similar, but they will have completely different tax consequences for purposes of the assets tax if the debt is not deductible from the tax base. If a company leases an asset, the asset will show up among the assets of the lessor and will hence be included in the overall assets tax base unless the lessor is not an assets tax payer. The lessor could, for example, be a foreign company, an exempt organization, or an individual not in the business of leasing. Partly forestalling this avoidance possibility, the Mexican law subjects to the assets tax a person who otherwise would not be subject to assets tax but who leases property to a person who is subject to assets tax.[45] Tax planning is still possible under this regime because some taxpayers will pay income tax, while others will pay assets tax. The latter can save tax by leasing assets from the former at no additional tax cost to the former.

D. SPECIAL RULE FOR EXPANDING COMPANIES

Like any tax on capital, the assets tax has disincentive effects for investment. To address this concern, the Mexican law allows a taxpayer to make an irrevocable election to pay assets tax on the basis of assets as determined for the second year preceding the taxable year. This amount is adjusted for inflation. This election mitigates the disincentive effects of the tax for taxpayers making the election, but leads to some tax planning possibilities, particularly for growing companies.

A similar incentive could be provided by allowing companies to pay on the basis of the lesser of the opening or closing asset balance.

5. *Exceptions for Nonproductive Periods*

At certain times, assets may not generate income, for example, during construction. In response to this problem, assets tax laws often exclude assets from the tax base for specified periods of time before the generation of income. For example, in Mexico, the assets tax provides for certain periods during which no assets tax is due: (1) what the law calls the preoperative period, (2) the first two years in which activity is begun, and (3) the year of

[44]MEX ATL art. 4.

[45]MEX ATL art. 1. The liability extends only to the property leased.

liquidation.[46] These exemptions can be criticized as a matter of theory: economic income can be expected to accrue even before there is cash flow.[47] However, the exception is understandable inasmuch as it matches the realization rules of the income tax and is consistent with the taxpayer's cash flow available to pay the tax. The exception complicates the assets tax, however, because it requires the determination of sometimes difficult questions of fact over which the taxpayer can exercise considerable control. Tax planning (including transfer pricing) opportunities are also created by the exemption of certain taxpayers, even if they are exempted for only a limited time.

6. *Relation Between Assets Tax and Income Tax*

A. Qualification for Foreign Tax Credit

Assuming that the assets tax takes the form of a minimum tax, the general principle is that the taxpayer pays the greater of the two levies. Implementation of this principle requires some care, however. To preserve the maximum foreign tax credit in the United States (or other countries with similar rules), it is desirable to structure the assets tax so that payments of income tax are creditable against it, rather than the other way around or rather than having the taxpayer pay the greater of the two amounts.[48] No foreign tax credit is allowed in the United States for the excess of the assets tax over the income tax. It is also necessary to specify how the rules for payment of estimated assets tax and income tax are coordinated.

B. Carryovers and Carrybacks

Perhaps the most difficult question is what to do about the problem of taxpayers who switch between paying the regular income tax and paying the minimum tax. There is no reason to require a taxpayer to pay more overall tax if its actual income fluctuates from year to year instead of remaining constant. In Mexico, taxpayers are allowed to carry forward the excess of assets tax over income tax to years when they have an excess of income tax over assets tax, and to be refunded assets tax to this extent.[49] Of course, this approach is complex, especially if the amounts of tax for the years in question are changed on audit, because all the years have to be recalculated if one is changed. Nevertheless, a carryover mechanism is necessary in order to provide equity between taxpayers in similar economic positions.

The amount of assets tax carried forward is adjusted for inflation in Mexico and should be adjusted in countries that generally practice inflation adjustment.

[46]The Colombian law contains exceptions for assets affected by force majeure and assets related to enterprises in a nonproductive period. *See* COL ET §189.

[47]*See* McLure et al., *supra* note 24, at 141.

[48]*See* Rev. Rul. 91-45, 1991–92 C.B. 336.

[49]*See* MEX ATL art. 9.

Because the Mexican tax allows a carryforward, but not a carryback, of assets tax in excess of income tax, it does not take care of all problems involving fluctuation in income. For example, suppose that assets and income tax liability of two Mexican taxpayers X and Y are as follows:

	X	X and Y	Y
	Income Tax	Assets Tax	Income Tax
1985	80	60	60
1986	90	85	85
1987	100	89	89
1988	110	100	100
1989	50	100	96
Total	430	434	430

Taxpayer X pays income rather than assets tax in all years up to 1989. Suppose that in this year it suffers a drop in business because of unfavorable trade conditions. Under a three-year carryback rule (which is not available in Mexico), it could carry its excess assets tax liability of $50 back to the three preceding taxable years. It would obtain, therefore, a credit of $10 for 1988, $11 for 1987, and $15 for 1986, for a total of $36. Therefore, in 1989, it would pay income tax of $50 and assets tax of $14.

Compare the situation of Y, which has the same total income tax liability as X, except that it is distributed in a different pattern from year to year. Because X is not allowed a carryback under the rules in effect in Mexico, it is disadvantaged relative to Y, which has a steadier stream of taxable income.

c. Nondeductibility of Assets Tax

It is generally provided that the income tax itself is nondeductible for income tax purposes. Payments of the assets tax should similarly be stated to be nondeductible in determining taxable income for income tax purposes, because the assets tax serves as a minimum income tax.[50]

7. *Foreign Tax Credit*

Assuming that the assets tax base includes assets held abroad, it is necessary to prevent double taxation, along similar lines as double taxation is avoided under the income tax by granting a foreign tax credit. Because the assets tax is a minimum tax, the relief for double taxation must be coordinated with the allowance of a foreign tax credit under the income tax.

In Mexico, a foreign tax credit is allowed against the assets tax for foreign income taxes paid by subsidiaries of the taxpayer.[51] Foreign taxes that are paid

[50]*See* VEN ATL art. 12.

[51]MEX ATL art. 9.

by the taxpayer itself are in effect creditable against the assets tax in that the amount of income tax that is credited against the assets tax is the amount of income tax liability, without reduction for the foreign tax credit.[52]

8. *Valuation*

Valuation is the Achilles heel of the assets tax. The tax would work reasonably well if the base were the fair market value of the taxpayer's assets. But if, as is customary, the value used is the tax cost for income tax purposes, then there can be a substantial deviation from fair market value. In the case of real property, one could use the assessed value for purposes of the real property tax, but the effectiveness of doing so depends on the quality of the assessments that are made for purposes of the property tax. The practical limitations on valuing property for purposes of the presumptive tax will ordinarily result in a substantial understatement of its value. Taxpayers will complain about overvaluation but will keep silent in the case of undervaluation.

Using the valuation of property for income tax purposes favors taxpayers who can avoid realizing gains, because such realization will lead to a permanent increase in future assets tax liability. As far as the assets tax is concerned, taxpayers who hold substantially appreciated property are in an advantageous position until they sell the property.

If the income tax is explicitly adjusted for inflation, the inflation-adjusted values can be used directly for the assets tax. Often, instead of the income tax being adjusted for inflation explicitly, ad hoc methods are used to compensate for inflation or to grant favored treatment for particular investments. Thus, inventories may be valued under the last-in-first-out (LIFO) method, and depreciable assets may be accounted for using accelerated depreciation. Such methods understate the value of the assets in question, sometimes substantially so. If these values are used for assets tax purposes, distortions will result. Conceivably, assets could be valued differently for assets tax and income tax purposes, but this would involve some complexity. Valuation is a particular problem for intangible assets (such as goodwill and the results of research and development) whose cost is expensed for income tax purposes.

9. *Exemptions*

If it is desired to maintain certain income tax exemptions, analogous exemptions must be provided for assets tax purposes. For example, suppose that

[52]For example, suppose that the domestic tax rate is 50 percent, foreign income is $40, foreign tax is $20, and total income is $100. If assets tax liability is $53, then the amount of assets tax to be paid is $3 (i.e., $53 reduced by pre-credit income tax of $50), and the amount of income tax to be paid is $30 ($50 reduced by the foreign tax credit of $20). If the amount of foreign tax were higher—say, $25—then the taxpayer would still pay the same amount domestically because the foreign tax credit limitation would be $20.

the income from state bonds is exempt from income tax. The value of the bonds would have to be excluded from the assets tax base in order to maintain the effectiveness of the exemption.

10. *Tax Planning*

Tax planning opportunities have been mentioned in several contexts in discussing the assets tax. In general, because some taxpayers pay income tax rather than assets tax, others pay assets tax, and yet others are exempt from assets tax for periods of time, incentives are created for shifting property, loans, or income from one taxpayer to another (or, in some cases, from one year to another). Some possible techniques for shifting assets and loans have already been described. Income can also be shifted from taxpayers who pay income tax to taxpayers who pay assets tax via transfer pricing and other techniques (such as acceleration or deferral of payments). Indeed, it is inevitable under a minimum tax such as the assets tax that some taxpayers will pay it and some will not, so that tax planning opportunities cannot be eliminated completely, although they can be diminished by adopting an assets tax with a minimum level of exceptions. As the discussion above demonstrates, the design of an assets tax involves complex issues. No matter how the tax is designed, taxpayers can be expected to engage in transactions to minimize their tax liability. Therefore, adopting this tax increases the transactional complexity of the system. On the other hand, assuming that the tax rate is fairly low, one has to shift a lot of assets to show a significant tax savings. Given a certain level of transaction costs for tax planning techniques, the extent of tax planning can therefore be expected to be limited.

11. *Assets Tax with Partial Scope*

A variant on the gross assets tax is a presumptive tax based on particular assets, which supplants only a portion of the income tax base. This approach has been applied to income from immovable property, whereby instead of taxing actual income a specified percentage is applied to the value of the immovable property.[53] While the presumption may be more or less valid over the long term, it can be quite inaccurate as applied to the income of a particular year if the income from the land tends to fluctuate. This suggests that there would be advantages to structuring such a tax as an exclusive presumption, which would also have better incentive effects. Such a tax would, however, be quite crude and unfair if valuation were not accurate, nor would it correspond to the criterion of ability to pay.

[53]This method was formerly applied in the United Kingdom. *See* Income Tax Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2 ch. 10, sec. 82 (sched. A). Under this scheme, certain rented property was taxed according to the actual rental.

D. Industry-Specific Methods for Small Businesses

Minimum taxes based on turnover or assets can be applied to all taxpayers, including large companies. When the focus is on the taxation of small businesses, a number of presumptive methods that are more tailored to specific industries have been applied in various countries. Some of these are described below; other variants exist.

1. *Fixed Amounts Based on Profession or Trade*

Some countries apply a minimum tax based on an individual's profession or trade.[54] To avoid serious inequity, the presumptive amounts must be set at rather low levels. They are thus ineffective in taxing higher-income professionals. Indeed, if the presumptive tax raises substantial revenue, this is a sign that there is something seriously wrong with the regular tax. Perhaps these presumptive amounts are better than nothing, however. A slightly more refined alternative is to divide taxpayers within a given industry into two or three classes based on turnover, with a fixed tax for turnover within each band.[55] Taxpayers may also be divided into categories based on the type and amount of capital equipment used in the business; for example, owners of slot machines could be taxed on a fixed amount for each machine owned.[56] A distinction is also sometimes drawn based on the number of years a person has been out of school. If the presumption is applied as an exclusive rather than as a minimum tax, it is important to specify a turnover ceiling above which it no longer applies.

2. *Contractual Method*

The contractual method (*forfait*[57]) used in France is a presumptive method that strives for a fair degree of accuracy. For a time, the *forfait* was widely applicable in France, covering some one million individual business persons as of the 1960s,[58] although its importance has dwindled more recently. Taxpayers are eligible for the system if their annual turnover is below a speci-

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[54]*See, e.g.*, ALB SBT art. 3; KAZ TC art. 138(1). *See* Lapidoth, *supra* note 2, at 33–35 for discussion of standard assessments in Ghana, which were fixed amounts for specific trades.

[55]*See* Richard A. Musgrave, *Income Taxation of Hard-to-Tax Groups in* Taxation in Developing Countries (Richard M. Bird & Oliver Oldman eds., 4th ed. 1990).

[56]*See* Lapidoth, *supra* note 2, at 34.

[57]The term *forfait* is linguistically confusing, because it can refer both to a contract and to a lump-sum payment. According to International Tax Program, Harvard Law School, Taxation in France 345–62 (1966), the term means "contract" in this context. Because *forfait* is also used to refer to other presumptive methods used in France, the term "contractual method" is used here to refer to this particular kind of *forfait*. *See* Précis de fiscalité ¶¶ 1341–62 (1994) for a description of its current operation in France. The discussion above draws from the more detailed discussion in Taxation in France.

[58]*See* Taxation in France, *supra* note 57, at 345.

fied amount. The contractual method differs from other presumptions in that its application is based on advance agreement between the taxpayer and the tax authority to base tax liability on estimated income instead of on actual income.[59] The rules for eligibility for the *forfait* and for the procedure of its application are set forth in the statute.[60] The methodology for determining taxable income for purposes of the *forfait* to be applied by tax inspectors is set out in administrative manuals and circulars.

To apply the *forfait*, the taxpayer must furnish the following information with respect to the preceding year: purchases, sales, value of closing inventory, number of employees, amount of wages paid, and number of cars owned by the taxpayer. The tax administration then calculates the *forfait*, which is supposed to be an estimate of the "income which the enterprise can normally produce." As can be seen, the information furnished by the taxpayer requires a substantial amount of record keeping and, in fact, constitutes virtually all the information needed to determine taxable income, except for general business expenses. These are furnished by the tax administration, on the basis of industry-specific estimates. Once the administration supplies its estimated income, it is then subject to agreement with the taxpayer. The agreed figure applies for two years, that is, the preceding year and the current year. It may be different for each of these years, and the figure for the second year may be extended for one or several successive one-year periods.

The taxpayer has the option to use regular income accounting instead of the *forfait* method but, if electing the regular method, is bound to use it for three years.

Similar approaches apply in some other countries.[61] In Belgium, the tax authorities may agree with the taxpayer on a presumptive assessment that remains valid for three consecutive years.[62] The method is restricted to taxpayers not in a position to keep proper accounts.

The estimation methods for determining the amount of the *forfait*, which are based on extensive statistical analyses conducted by the tax administration and on a detailed classification of industries, involve a lot of sophisticated work. Moreover, the application of the *forfait* depends on high-quality and honest tax inspectors:

> Since it is the local tax inspector who has authority to reach an agreement with the taxpayer, the caliber of the administration, especially the ability and honesty of the local inspector, is important to the success of the agreed income system. . . . In sum, the essence of the agreed income system is strong

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[59]*See* Lapidoth, *supra* note 2, at 89.

[60]*See* FRA CGI arts. 302 *ter*, 302 *quinquies*, 302 *sexies*, 302 *septies*.

[61]*See, e.g.*, *Note, The Tachshiv in Other Countries*, 31 Bulletin for International Fiscal Documentation 101 (1977) (describing provisions in the tax laws of several European countries that allow the taxpayer and the tax authorities to agree on a tax assessment).

[62]*See* BEL CIR arts. 342, § 1er, 343, § 1er.

administration at the local level, with supervision at departmental and national levels.[63]

These factors suggest that the *forfait* may not be appropriate for many countries, and that careful consideration and planning should be undertaken before contemplating the introduction of such a scheme.

3. *Methods Based on Turnover*

Some countries tax particular types of income or income from specific industries on the basis of turnover, with presumptive deductions based on ratios developed for the industry or type of income in question.[64] This method responds to criticisms of the gross receipts method that there are different profit rates in different industries. However, it requires more research (and distinction among industries) to apply. This more finely tuned method is, however, suitable only for smaller businesses. Large companies would find it difficult to apply because they may operate in many lines of business. Their more complex structures also make it difficult to calculate an appropriate profit percentage.

4. *Standard Assessment Guides*

Standard assessment guides (*tachshivim* as used in Israel,[65] subsequently replaced by *tadrihim*) and similar methods are used in several other countries.[66] The *tachshiv* is based on various ascertainable factors, which are developed for particular industries. For example, a restaurant may be taxed on the basis of location, number of seats, and average price of items on the menu. The objective is to determine net profit. The *tachshiv* does involve an element of agreement between taxpayers and the tax authorities, but the agreement is on the *tachshiv* in general (being negotiated with industry representatives), not on its application to particular taxpayers.

Although the general approach of the *tachshiv* is similar to that of the *forfait*, its legal status in Israel is different. It was not specifically authorized by the statute, other than being covered by the general authority to make best judgment assessments. Since the *tachshivim* were published, taxpayers in practice have relied on them, failing to keep or disclose adequate records in situations

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[63]Taxation in France, *supra* note 57, at 357.

[64]For example, in France, in the case of income from the rental of immovable urban property, a deduction fixed as a specified percentage of gross receipts is allowed in lieu of an itemized deduction for depreciation, insurance expenses, and management expenses. Other expenses are, however, deductible in their actual amount. FRA CGI art. 31(I)(1)(e).

[65]The discussion here is based on Arye Lapidoth, *The Israeli Experience of Using the Tachshiv for Estimating the Taxable Income*, 31 Bulletin for International Fiscal Documentation 99 (1977). Other countries using similar methods include Spain and Turkey. The Musgrave proposal is also similar. *See* Musgrave, *supra* note 55.

[66]*See, e.g.*, ESP IRPF art. 69 (determination of income of small and medium enterprises on the basis of objective factors).

covered by a *tachshiv*, particularly when the results were advantageous to the taxpayer. One implication is that the *tachshiv* system resulted in understatement of tax, since it was a one-way street: taxpayers would rely on the *tachshiv* where favorable but keep records where that would be more favorable. While the existence of the *tachshiv* system did not relieve taxpayers of their obligation to keep adequate records, in practice taxpayers were not penalized for such failure. In reviewing cases involving assessment based on a *tachshiv*, courts held that the assessment could be altered by the court if the taxpayer could show that it was arbitrary in the particular case.

Another important difference between the *tachshiv* as applied in Israel and the *forfait* is that the latter is available only to taxpayers with a turnover below a specified amount, whereas the *tachshiv* is not so restricted.

Use of a method such as the *tachshiv* may be effective in extracting tax from small taxpayers in certain industries, but it is not easy to apply. Considerable background work is required by the tax authorities in specifying the factors to be used for particular industries and the relevant multipliers for each factor. Application of this method thus requires an investment in administrative infrastructure and adequate preparatory time. The method will be more suitable for some industries than for others. The key is whether the business is such that turnover can be ascertained from external evidence. Where it can, a *tachshiv*-type approach may be appropriate, provided that adequate administrative preparation is made.

In drafting provisions for standard assessments, it would be better to avoid the uncertain legal situation experienced by Israel and instead to provide statutory authority for their use. Because the determination of standard assessments involves considerable detail and empirical research, the details for their application cannot be contained in the statute. Taxpayers for whom the standard assessment is applicable should be specified, preferably on the basis of a turnover test along the lines of that used for VAT or for the requirement to use accrual accounting under the income tax. An important issue is whether for these taxpayers the standard assessment should be elective or mandatory. The preferable solution is to provide for mandatory use of the standard assessment for taxpayers with turnover below the threshold, but to allow the taxpayer to make an irrevocable election to use the normal accounting rules instead.

5. *Taxation of Agriculture*[67]

In many countries, income from agriculture is taxed on a presumptive basis if it is taxed at all.[68] The usual approach is to base the tax on the area of land and its quality. An estimate is made of the normal income that can be earned,

[67]*See* Ahmad & Stern, *supra* note 1, at 252–59; Richard Bird, Taxing Agricultural Land in Developing Countries 63–66, 147–50 (1974); Lapidoth, *supra* note 2, at 37–40.

[68]*See, e.g.*, DEU EstG § 13a (presumptive assessment of certain agricultural enterprises).

given the productivity of that type of land, average costs of production, and the price of products. Relief may be provided for when the harvest in an area is bad. Certain activities may be excluded from presumptive taxation, and larger enterprises may be taxed on the basis of actual income.

For example, in France, farmers with a turnover of F 500,000 or less are eligible for the presumptive basis of taxation.[69] The taxable income from agriculture is determined according to (1) the area of land that is under cultivation or could be placed under cultivation, (2) the type of crop, and (3) the region. For each region, the average profit for each type of crop is determined annually by a committee composed of representatives of the tax administration and farmers. If a natural disaster leads to crop loss in a region, then individual farmers who suffered from the calamity may apply for a reduction in tax on that basis. The basic rules for the presumptive taxation of agriculture are set forth in the statute.[70]

E. "Outward Signs" of Lifestyle

A presumptive minimum tax based on outward signs of lifestyle has operated for a long time in France. Similar systems apply in several Francophone countries of Africa as well as in some other countries.[71] In France, the presumption applies to all individuals, regardless of profession. Its application is discretionary, and the tax authorities have been instructed not to apply it when it would result in an exaggerated tax burden.[72] The presumption is based on certain outward signs of conspicuous personal consumption, which are specified in the statute. The signs of lifestyle of the taxpayer's spouse and dependents are aggregated. Not only ownership, but effective enjoyment, of items such as vacation homes and yachts, is taken into account; brief possession, for example, for one month or less, is usually ignored.

Under article 168 of the General Tax Code of France, the following items are taken into account: rental value of the principal residence, rental value of

[69]This description of the French system is based on Précis de fiscalité ¶¶ 314 to 342–43 (1994).

[70]FRA CGI art. 64.

[71]*See, e.g.*, GIN CIDE art. 31 (rebuttable presumption based on rental value of principal and secondary residences, domestics, and automobiles). In Mali, presumptive taxation is based on rental value of principal and secondary residences and automobiles. *See* MLI CGI art. 13. In Mauritania, presumptive taxation is based on the rental value of the principal and secondary residences, domestic servants, and automobiles. *See* MRT CGI art. 105. In Togo, presumptive taxation is based on rental value of principal and secondary residence, domestic servants, automobiles, motorcycles, tourism planes, travel abroad (plane tickets), and pleasure boats. *See* TGO CGI art. 124. Lesotho has recently adopted a presumptive tax based on lifestyle factors. *See* LSO IT § 16.

[72]*See* Francis Lefebvre, Documentation pratique des impôts directs, Série Impôts sur le revenu des personnes physiques V (Feuillet No. 2) ¶¶ 290, 300 (March 1, 1983). Francis Lefebvre, Documentation pratique-Fiscal §§ 850–1080 (July 1, 1989).

secondary residences, number of domestic employees, automobiles, motorcycles, pleasure boats, airplanes, horses, hunting rights, and golf club memberships. For each item, a fixed amount per unit (in the case of domestics, boats, airplanes, and horses) is taken into account or the amount spent or value of the item is multiplied by a specified figure. The total is then compared with taxable income computed under the normal methods. If the presumptive calculation exceeds the normal calculation by more than one-third in both the current year and the preceding year, then the taxpayer is taxed on the amount resulting from the presumptive calculation. The presumptive calculation only applies, however, if the result exceeds an amount specified in the statute. For items taxed according to a fixed amount that have been at the taxpayer's disposition for only part of the year, a pro rata portion is taken into account, and situations involving a brief time only are ignored.[73] If an item is attributable to the taxpayer via a dependent and if the dependent attains majority during the year, again a pro rata portion of the item is taken into account.[74] If several persons are entitled to use a particular item, the base for the item is divided proportionally among them according to their respective rights.[75]

Losses carried forward from earlier years cannot be used to reduce the presumptive taxation, but they may be carried over to subsequent years. In drafting a rule of this kind, it may be helpful to spell out this result. Losses incurred in the year of application of the presumption may be carried over to future years.[76] The treatment of losses generated in the year of application of the presumption can be resolved by providing that taxable income for the year is no less than the amount specified according to the presumption; in this case there will be no such loss.

Because the comparison was to be made between presumptive and declared income, the French courts have held that article 168 applied only in cases where the taxpayer had filed a return.[77] To avoid this result, the drafter should make application of the rule independent of whether the taxpayer has filed a return or not. The French statute was so amended in 1986. The French courts have also held that adjustments to income made by the tax authorities

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[73]*See* Francis Lefebvre, Documentation pratique des impôts directs, Série Impôts sur le revenu des personnes physiques V (Feuillet No. 6) ¶¶ 1130, 1140 (July 1, 1985). Francis Lefebvre, Documentation pratique-Fiscal § 4285 (July 1, 1989).

[74]*See id.* § 1150; Francis Lefebvre, Documentation pratique-Fiscal § 4450 (July 1, 1989).

[75]*See* FRA CGI art. 168(1), para. 3.

[76]*See* Francis Lefebvre, Documentation pratique-Fiscal, Série Impôts sur le revenu des personnes physiques V (Feuillet No. 19) §§ 10510–90 (May 1, 1995). The situation was previously less clear. *See* Conseil d'Etat, July 26, 1978, 5,679 Lebon 328. *Compare* Conseil d'Etat Oct. 15, 1980, 16,603 Lebon 367 *with* Francis Lefebvre, Documentation pratique des impôts directs, Série Impôts sur le revenu des personnes physiques V (Feuillet No. 17) ¶¶ 3660, 3670 (Mar. 1, 1983).

[77]*See* Conseil d'Etat Mar. 21, 1975, 85,496 Lebon 217; Conseil d'Etat July 2, 1975, 83,242 Lebon 397.

are not to be taken into account in determining whether the presumptive income exceeds the declared income by at least one-third.[78]

The presumption was for a long time irrebuttable in France. In 1986, article 168 was amended to allow taxpayers to challenge its application by proving that their actual income was less than their presumed income. Which approach makes sense in a particular country is a matter of judgment. If the presumption is made rebuttable, taxpayers may bring court challenges that the tax administration will not win if it does not have sufficient information about the taxpayer. If the presumption is irrebuttable, its application will be unfair in some cases. In France, this problem was dealt with by instructing tax inspectors to apply the presumption only in cases where it was justified and by requiring a senior tax inspector to approve the application of the presumption.[79]

The French system results in an increase in tax for some taxpayers, but the number of cases involved is small and has decreased over time. For example, in 1960, the French Ministry of Finance reported that this regime resulted in a tax increase for 1,300 individuals,[80] but only several dozens of cases can be reported today.

As a matter of procedure, it may be helpful to the application of the method to require taxpayers to include on their returns the necessary information to establish the presumption, and even to self-assess the resulting tax in the cases of countries with self-assessment for the income tax. The obligation to include this information on the return can be limited to taxpayers whose factors for applying the presumption exceed specified amounts, so that in practice only a small number of taxpayers would have to supply this information.[81]

In drafting provisions for such a system to apply in a particular country, consideration should be given to the consumption patterns of wealthy individuals in that country, and as to whether there are any factors of a mechanically determinable nature that can be added to the list. Possibilities include the amount of electricity consumed and the amount paid for private school tuition.[82] The whole formula for applying the presumption, including the factors to be used and the amount of income to be imputed on the basis of each factor, should be set forth in the statute. This is because, unlike with the standard assessment guides, there is no need to make a detailed analysis of different industries and to delegate this work to the tax authorities. As an illustration of a set

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[78]*See* Conseil d'Etat, April 24, 1981, 9,665 Lebon 189.

[79]*See* Francis Lefebvre, *supra* note 72, at ¶ 310; Francis Lefebvre, Documentation pratique-Fiscal, Série Impôts sur le revenu des personnes physiques V (Feuillet No. 16) § 8910 (July 1, 1989). The requirement relating to an approval by a senior tax inspector has been maintained after the presumption became rebuttable. *See* LPF art. R 63-1.

[80]Taxation in France, *supra* note 57, at 364, n.286.

[81]This is the rule in Lesotho. *See* LSO IT § 16. It was previously the rule in France, but the requirement to include information about the presumption on the return was eliminated. *See* Précis de fiscalité ¶ 181.

[82]*See supra* note 71 for other factors used in various African countries.

of rules adopted in an African country, a description of the relevant provisions from the Income Tax Act of Lesotho is set forth in Appendix A.

F. Conclusion

Some countries make little use of presumptive methods of taxation, given that such methods inherently involve unfairness, because they involve a departure from the normal accounting methods used to determine the tax base. Taxpayers who genuinely have no income might end up having to pay tax under a presumptive method that is not rebuttable.

On the other hand, if compliance with and administration of the income tax are so uneven that the normal rules do not lead to equal treatment of taxpayers with equal income, then presumptive methods may prove attractive. Of fundamental importance is the capacity of the tax administration to handle the particular presumptive method. For example, where corruption of tax service personnel is a serious problem, then an approach along the lines of the French contractual method is a recipe for disaster. To take another case, the *tachshiv* approach, which involves detailed study and preparation, should be undertaken only if the necessary groundwork has been laid.

Attention must also be paid to how a particular presumptive method will work in practice. If taxpayers can hide the factors on which the presumption is based as easily as they can hide income, then the presumption will not be of much use. This is an empirical question, which also depends on the administrative capacity of the tax authorities, and the appropriate methods will therefore differ from country to country.

Another element to take into account in evaluating whether and how presumptive approaches should be used is that presumptions can involve the granting of a tax preference. Depending on how a presumption is determined and applied, it can result in a reduced burden for particular kinds of taxpayers. This is particularly the case where the presumption is elective, as under the French contractual method. Thus, the purpose of the presumption can become the protection of a certain group of taxpayers (e.g., small business or farmers) rather than protection of revenue. In cases where the presumption is preferential, its application is often limited. For example, it may be available only for taxpayers with a turnover below a certain amount. In some cases, the availability of the presumptive method may depend on the legal form of business organization. For example, if all legal persons are required to keep books under the commercial code, then the use of presumptions may be restricted to physical persons. While this approach has some justification, it has the disadvantage of discouraging incorporation in situations where the presumptive method is advantageous to the taxpayer.[83]

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[83]*See* Lapidoth, *supra* note 2, at 93–96.

As the discussion in this chapter shows, once a decision has been made to adopt a particular presumption, the design and drafting problems are the same as those for any other tax: in effect one has made a decision to impose a new tax, which involves its own problems and which may or may not be linked with another tax (in most cases, the income tax) as a minimum tax. Purely from the point of view of complexity of statutory language, adding presumptions is not a simplification, even if it is designed to ultimately simplify administration. As with any tax, if care is not taken in drafting, problems will emerge when the new regime is put in place.

Appendix A. Lesotho Provision on Outward Signs of Lifestyle[84]

Section 16 of the Income Tax Act of Lesotho provides an alternative method of calculating the chargeable income of those taxpayers with low reported chargeable income but visible signs of substantial wealth. Under section 16, a taxpayer's minimum chargeable income is calculated on a presumptive basis having regard to visible signs of wealth to which objective values are assigned. The indicators of wealth used in determining minimum chargeable income are air travel, electricity consumption, value of the taxpayer's principal residence, school fees, the value of a secondary residence, and the value of the taxpayer's motor vehicle.

If the chargeable income of a resident individual calculated under the normal rules is less than the minimum chargeable income calculated under section 16, then the individual's chargeable income is the minimum chargeable income.[85] This method of taxation is included in the new law in response to the low level of compliance that has been detected among some wealthy taxpayers. The provision applies automatically without any need for proving that income has been concealed.[86]

Minimum chargeable income is calculated in such a way that it does not apply to most resident individuals. For example, this section does not apply to a resident individual whose income (other than income subject to a final withholding tax such as interest) consists solely of employment or pension in-

[84]Adapted from the Explanatory Memorandum to the Income Tax Act 1993.

[85]In this respect, the scheme differs from that applicable in France: the French system takes the previous year into account and applies only if the presumptive calculation exceeds the regular calculation by more than one-third. The French rule results in additional complexity, but it responds to the situation where there is a temporary reduction in income for the taxable year (the previous year's income being high enough so that the presumption does not apply).

[86]Except that, in the case of a taxpayer who declares only employment or pension income, the tax administration must prove that the taxpayer received some income from other sources in order for the presumption to apply. The amount of this other income need not, however, be proved.

come.[87] The justification for this rule is that this type of income is generally difficult to hide; it simplifies the system by removing most taxpayers from the scope of the presumptive tax. In this respect, the system in Lesotho differs from that of France, where no distinction is drawn among sources of income. Further, this section does not apply to a resident in receipt of employment or services income that is entitled to diplomatic or similar exemption or that is exempt under a treaty or other international agreement. In the case of a husband and wife where neither spouse is excluded under the above rules, this section applies to the spouse with the greater chargeable income calculated under the normal rules. Finally, each of the indicators of wealth is taken into account only if it exceeds the threshold prescribed in a schedule to the act.[88] Most taxpayers will not have amounts that exceed the thresholds. Even where a taxpayer does have amounts that exceed the threshold for one or more indicators of wealth, the presumptive calculation will have no effect on tax liability where it is less than the taxpayer's chargeable income calculated under the normal rules.

A taxpayer's minimum chargeable income is the sum of the amounts calculated with respect to each of the indicators of wealth. No deductions are allowed in calculating the minimum chargeable income of a taxpayer. This means, for example, that the deduction for dependents or the deduction for a loss carried forward is not taken into account in calculating minimum chargeable income.

In general, the indicators of wealth taken into account include those for the spouse and minor children. The French rule substitutes "dependents" for "minor children." Reference to minor children is a simpler rule and prevents taxpayer arguments that certain children should be excluded from the calculation because they do not qualify for the dependency allowance (e.g., if their income exceeds the specified threshold for the dependency allowance).

The first component of minimum chargeable income is the air travel amount. The air travel amount of a taxpayer is the total cost of air or sea travel of the taxpayer, the taxpayer's spouse, and the taxpayer's minor children. The air travel amount does not include travel on the taxpayer's employer's business, but does include travel on the taxpayer's own business. The air travel amount is taken into account only if it exceeds M 2,500[89] for the year of assessment, in which case the whole amount is considered.

[87]Under this rule, it is possible that a taxpayer with income other than employment or pension income could escape the scheme by completely hiding such other income. It is assumed that it would be quite difficult to completely hide a substantial source of income. To apply the scheme, the tax authorities would have to prove only that the taxpayer received some income other than from employment or pensions.

[88]This is another point of difference with the French system. Under the French system, all the factors are taken into account and added up before applying a threshold.

[89]US$0.28 = 1 loti (plural maloti; currency abbreviation, M).

The second component of minimum chargeable income is the electricity amount. The electricity amount is the value of electricity consumed in the taxpayer's principal residence and secondary home. If there is more than one secondary home, then the electricity amount includes the value of electricity consumed in each home. The electricity amount is determined by reference to accounts rendered for electricity consumption during the year of assessment. The electricity amount is taken into account only if it exceeds M 3,000 for the year of assessment, in which case the whole amount is considered.

The third component of minimum chargeable income is the principal-residence amount. The principal residence of a taxpayer is the residence (whether in Lesotho or elsewhere) at which the taxpayer spends most of his or her time during the year of assessment. The calculation of this amount depends on whether the principal residence is owned or rented by the taxpayer or the taxpayer's spouse. If it is owned, then the amount is the greater of the adjusted cost base of the residence or the value of the residence for the purposes of property rates. If the residence is rented, the principal-residence amount is the greater of eight times the actual annual rental or eight times the annual fair market rental for the year of assessment. The principal-residence amount is taken into account only if it exceeds M 150,000. If it does exceed this threshold, 5 percent of the principal-residence amount is included in minimum chargeable income.

The fourth component of minimum chargeable income is the schooling amount, consisting of tuition and related fees incurred in respect of the taxpayer's minor children during the year of assessment. Related fees include, for example, the cost of books, excursions, and after-hours tutoring. The schooling amount is taken into account only if it exceeds M 1,000 per child, in which case the whole amount is included in minimum chargeable income.

The fifth component of minimum chargeable income is the secondary-home amount. The secondary home of a taxpayer is a residence (whether in Lesotho or elsewhere) available for use by the taxpayer or the taxpayer's spouse or minor children.[90] If the taxpayer has more than one secondary home, then each is taken into account under this heading. The secondary-home amount is calculated in accordance with the same principles as for the calculation of the principal-residence amount and is taken into account only if it exceeds M 20,000. If it does exceed this threshold, 5 percent of the amount is included in minimum chargeable income.

[90]In France, a residence has been held as available for use even when it has been offered for sale and in fact is not used, *see* Conseil d'Etat Oct. 15, 1980, 16,605 or when the taxpayer has allowed a relative to live there. *See* Conseil d'Etat July 10, 1981, 21,354, *available in* LEXIS, Intlaw Library, FRPBCS File. When the taxpayer puts the residence up for rent, it is considered as being at his or her disposal until it is actually rented. *See* Conseil d'Etat Mar. 29, 1978, 3,856, *available in* LEXIS, Intlaw Library, FRPBCS File.

The final component of minimum chargeable income is the vehicle amount. This is the value of a motor vehicle[91] or vehicles owned or used by the taxpayer, the taxpayer's spouse, or the taxpayer's minor children. It does not include, however, the value of a vehicle that is wholly used for business purposes.[92] The value of a motor vehicle is determined in accordance with tables that are to be published by the Commissioner and is taken into account only if it exceeds M 20,000, in which case 25 percent of the amount is included in minimum chargeable income.

The application of section 16 is illustrated by the following example:

> Taxpayer is married with a spouse who does not derive any income and a ten-year-old child. The taxpayer receives a salary of M 60,000 and rental income of M 15,000, and has M 10,000 in deductions for the year of assessment (including the personal abatement). Taxpayer, therefore, under the normal rules has a chargeable income of M 65,000.
>
> During the year of assessment, taxpayer
>
> - spends M 10,000 in private air travel to Mauritius for his wife and child;
> - consumes electricity in the family home to the value of M 2,500;
> - has only one family home with an adjusted cost base of M 200,000 (this is higher than the value for the purposes of property rates);
> - incurs school fees of M 15,000 for his child; and
> - has a vehicle available for private use with a value of M 25,000.
>
> Because taxpayer derives rental income in addition to his salary, he is subject to section 16. If the other income were interest, and subject to a final withholding tax, and not rental income, then section 16 would not apply.
>
> For the purposes of calculating minimum chargeable income, taxpayer has amounts for air travel, principal residence, schooling, and vehicle. Because the value of electricity consumed is less than M 3,000 (the threshold set out in the fifth schedule), no electricity amount is taken into account in calculating minimum chargeable income. Taxpayer's minimum chargeable income for the year of assessment is M 40,000 (being M 10,000 + (5 percent × M 200,000) + M 15,000 + (25 percent × M 25,000)). Because this is less than the chargeable income calculated under the normal rules, section 16 does not increase taxpayer's chargeable income.

[91]In France, only passenger automobiles are included. *See* FRA CGI art. 168. By administrative practice, automobiles older than 10 years or that no longer function are not taken into account. *See* Francis Lefebvre, Documentation pratique-Fiscal, Série Impôts sur le revenu des personnes physiques V (Feuillet No. 12) § 6800 *et seq.* (July 1, 1989).

[92]A similar rule applies in France. *See* Conseil d'Etat, Oct. 21, 1981, 23,679, *available in* LEXIS, Intlaw Library, FRPBCS File.

13

Adjusting Taxes for Inflation

Victor Thuronyi

> If we could but learn to number our days . . . we should adjust much better our other Accounts.
>
> —*Abraham Cowley (1667)*

Most countries do not adjust their tax systems for inflation, or do so only partially. When inflation reaches significant levels, however, its effects on the tax system cannot be ignored. The best remedy is to bring inflation under control; when this is not possible, it is often desirable to adjust the tax system to inflation in some manner.

This chapter discusses mechanisms of inflation adjustment for different taxes.[1] For taxes other than the income tax, the method of adjustment is rela-

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[1]There is a large body of literature on inflation adjustment of taxes. To try to cite it all would be beyond the scope of this chapter, which focuses on global adjustment along the lines of that adopted in Latin America, which most of the literature in English does not directly consider. For a survey and analysis of inflation adjustment in Latin America, *see* Organización de los Estados Americanos, Inflación y Tributación (1978). *See* Keith Rosenn, Law and Inflation 295–370 (1982) for a survey of both partial and global adjustment of the income tax in a number of countries. Vito Tanzi, Inflation and the Personal Income Tax: An International Perspective (1980) is a comprehensive study from an economic perspective. Some recent articles of relevance to developing countries are Dale Chua, *Inflation Adjustment, in* Tax Policy Handbook 142 (Parthasarathi Shome ed., 1995) and Milka Casanegra de Jantscher et al., *Tax Administration and Inflation, in* Improving Tax Administration in Developing Countries (Richard Bird & Milka Casanegra de Jantscher eds., 1992). The interested reader can find references to most of the literature by consulting the citations contained in the books and articles cited throughout this chapter.

tively simple as a conceptual matter and does not require extensive discussion.[2] Inflation adjustment of the income tax base is more complex, being related to the questions of timing that make the income tax so difficult to operate. Section III, which forms the bulk of this chapter, is devoted to the income tax. Global adjustment of the taxation of business income in an environment of high inflation is given particular attention for the following reasons. First, it is the only method that can work reasonably well under conditions of high inflation. Second, while it is well understood in the countries that use this method, it is less well known to tax experts in other countries. Third, once one understands global adjustment, one has a solid framework for analyzing partial adjustment methods (which include all adjustment schemes for taxpayers that do not practice double-entry bookkeeping). These differ substantially from country to country, and it would take lengthy discussion to do them justice, because their operation depends very much on how they fit in with the other tax rules of the country in question. This chapter therefore treats partial methods briefly, leaving their detailed analysis to others. Illustrative statutory language and technical commentary on global adjustment are contained in the appendices.

I. Effects of Inflation on Tax Liability—in General

To understand adjustment for inflation, it is helpful to distinguish among three effects[3] that inflation may have on real[4] tax liability. These are (1) erosion of amounts expressed in national currency, (2) erosion of the value of tax obligations, and (3) other effects on the measurement of the tax base. The techniques for compensating for each of these effects are different. They are discussed in sections A through C below. All, some, or none of these may apply to a particular tax. An example of a tax to which none of them applies is an ad valorem excise tax that is collected immediately; such a tax is unaffected by inflation and hence does not need adjustment. By contrast, the effect of inflation on the income tax is particularly complicated because all three effects are present.

A. Erosion of Statutory Amounts Expressed in National Currency

Every time a tax law contains an amount expressed in national currency, the value of this amount is eroded by inflation. Examples are (1) the levels at which the various tax rate brackets for the income tax begin and end, (2) the amount of the personal deduction for the income tax, (3) the amount of excise tax per unit

[2]*See infra* sec. II.

[3]These are similar to the categories identified in Hans G. Ruppe, *General Report, in* LXIIa Cahiers de droit fiscal international 89, 119 (1977). *See also* Tanzi, *supra* note 1, who draws conclusions similar to those outlined here.

[4]"Real" refers to an inflation-adjusted value, as opposed to "nominal," which is an amount in national currency without adjustment for inflation.

(if this is stated in terms of national currency), (4) the amount of turnover according to which the requirement to register for the value-added tax (VAT) is measured,[5] and (5) specific amounts for penalties. In the income tax (or any other tax with a progressive rate schedule), the most important amounts expressed in national currency will usually be the exemptions and the rate brackets.[6]

The effects of inflation on revenue caused by the erosion of amounts expressed in national currency do not all run in the same direction. Pushing taxpayers into higher income tax brackets raises revenue. Reducing the real value of fines reduces revenue. In the case of the income tax, because the exemptions, other personal deductions expressed in fixed money amounts, and the rate brackets are so important for revenue, the net effect of the erosion of amounts expressed in units of currency is to increase revenue. In the case of an excise tax with specific rates,[7] inflation reduces revenue.

The erosion of amounts expressed in national currency can be dealt with in a number of ways, the choice among these being largely a political one.[8] The most neutral and straightforward approach is to provide in the statute for automatic[9] adjustment, on a periodic basis, of any amounts expressed in terms of national currency. Another possible approach is to remove amounts expressed in national currency from the statute. For example, excise tax rates can be expressed ad valorem instead of as specific amounts.[10]

Inflation adjustment can be limited to specific items, while the value of others is allowed to erode.[11] The legislature can also enact periodic adjustments to rate brackets and other items instead of an automatic adjustment mechanism. But, in making these adjustments, the legislature would not be

[5]*See supra* ch. 6, sec. II(B).

[6]Inflation erodes the value of the income that falls within each of the rate brackets, thereby increasing average rates of tax and increasing the number of taxpayers subject to higher marginal rates. This phenomenon has been called "bracket creep": individual taxpayers whose real earnings do not increase from year to year find themselves in higher and higher income tax brackets, because their nominal incomes have increased owing to inflation. The same erosion takes place for other amounts in the statute that are expressed in national currency, for example, limits on various deductions, limits of annual turnover below which simplified accounting methods can be used, or amounts of fines.

[7]That is, where amounts of tax payable per unit of product are specified in units of national currency.

[8]There are also some technical issues, the main one being the frequency of adjustment. The appropriate frequency is largely a function of the inflation rate. At low rates, annual adjustment is adequate. At higher rates, wage withholding tables or specific excise tax amounts should be adjusted every month or even more frequently.

[9]"Automatic" refers to a mechanism whereby the tax administration, or the ministry of finance, is directed to publish, at specific intervals (usually annually or monthly), tables setting forth the inflation-adjusted figures, based on a specified price index. *E.g.*, USA IRC § 1(f). There would be no discretion in preparing the table, other than a limited discretion to round amounts up or down.

[10]Whether this is wise or not is debatable. *See supra* ch. 8, sec. I(D).

[11]For example, a limitation on the deduction of home mortgage interest may be enacted. If this amount is not adjusted for inflation, then it is in effect phased out over time.

confined to exactly compensating for inflation. It could enact a "tax reduction" that would be spread among different interest groups as the legislature decided.[12] Moreover, by acting with delay, the legislature can allow inflation to have an effect over an interim period.

B. Erosion of Tax Obligations

Taxes are obligations of the taxpayer to the government. Inflation erodes the value of these obligations because of collection lags, which represent the difference between the time that a tax obligation arises (i.e., the time that the taxable event occurs) and the time that the tax is paid.[13] The length of collection lags varies from tax to tax and often for different transactions covered by a single tax. With the income tax, the taxable event occurs at the time that income is received. The collection lag for the income tax varies according to the type of income. The tax may not be paid until after the end of the year, when the return is due. The tax on wages may be paid right away if it is collected through withholding. In this case, the collection lag may only be a few days, that is, the difference between the time the wages are paid and the time the withholding agent pays the withheld taxes to the budget. For the VAT, the collection lag is the difference between the date the sale occurs and the date the tax is due (typically, some time in the following month). Unless the obligation is indexed or unless interest must be paid for the period of the lag, inflation causes the real value of the tax obligation to erode, the extent of the erosion being dependent on the length of the collection lag.

The opposite can also occur. The government often ends up owing an obligation to the taxpayer, for example, when it must make a refund or when the taxpayer is entitled to carry over a deduction, such as a net operating loss deduction. If these are not indexed, their value is eroded.

The effect of inflation on tax revenues caused by collection lags is evident in the case of a sales tax. The taxable event is the sale. One should probably consider the sale as taking place in economic terms at the time when the benefits of use transfer to the purchaser. Depending on the scheme for when tax is due, there will be a certain lag between the sale and the time the tax is paid. The lag can arise, for example, because a sales tax return is filed, and tax paid, sometime after the end of the month (the lag is quite serious at high inflation rates when returns are filed on a quarterly or an annual basis).[14]

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[12]This was done, for example, in the United States in the 1970s until the brackets were adjusted starting in the early 1980s.

[13]*See* Vito Tanzi, *Inflation, Lags in Collection, and the Real Value of Tax Revenue*, 24 IMF Staff Papers 154, 155 (1977).

[14]Another question is the definition of when the sale takes place for tax purposes. A collection lag may arise if the law defines the taxable event as taking place after the economic occurrence of the sale. For example, the taxable event may be defined as the time of issuance of an invoice, which may be issued sometime after services are performed and paid for. If the taxable event is delayed to the time of payment, this may not be a problem (as long as interest payments for consumer credit are included in the tax base), since the amount of the payment (including interest) can be expected to be determined taking inflation into account.

A higher rate of inflation will decrease the effective rate of tax, the decrease being greater the longer the collection lag. If collection lags differ, inflation will decrease the relative yields of those taxes with longer lags. The same effect is produced by an increase in real interest rates, although the effect of inflation is typically more dramatic.[15]

The collection lag effect can be dealt with in different ways depending on the type of tax. One approach is to shorten the lag, particularly for those taxes with longer lags, by pushing forward the due date for payment of the tax or by requiring advance payments of tax. Collecting the tax through withholding, instead of through requiring payment with a return filed after the taxable event, will also shorten the collection lag. Another approach is to index tax liabilities for inflation occurring between the taxable event and the time the tax is paid.[16] This is particularly important for taxes (e.g., income tax) for which the collection lag is long and cannot be shortened as a practical matter. A short collection lag, particularly if it is uniform in length for different transactions subject to the tax in question, can also be compensated for by raising tax rates. However, the result will be accurate only if the inflation rate holds constant. To cover cases when tax is paid after the due date, it is important that an adequate rate of interest be charged between the due date and the date the tax is paid.

C. Measurement of Tax Base

When the tax base is measured in historical units, inflation distorts the measurement of the base.[17] This is easy to see, for example, in the case of a tax such as the real property tax, which is based on historical valuations. On the other hand, the real value of the base of some other taxes, such as sales tax or an ad valorem excise tax, is not affected by inflation at all. This is because the tax base is current market value, which automatically keeps up with inflation.

The income tax presents one of the more complicated cases under this heading. Determination of the income tax base involves adding and subtracting accounting entries made at different times during the year in units of national currency. In the absence of inflation, adding and subtracting these amounts is straightforward, but under inflation the units are not comparable.

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[15]*See* Tanzi, *supra* note 13, at 159 n.7.

[16]Obligations owed by the government to the taxpayer should also be indexed.

[17]Strictly speaking, only the effects of inflation on the measurement of the tax base, other than effects arising from the erosion of amounts expressed in the statute in terms of national currency, are included under this heading. For a discussion of effects of inflation and some policy alternatives, *see* Daniel Halperin & Eugene Steuerle, *Indexing the Tax System for Inflation in* Uneasy Compromise 347 (Henry J. Aaron et al. eds., 1988).

It is complicated to conceptualize inflation adjustment of the income tax, because both collection lags and tax base measurement are involved. In abstract terms, the income tax base can be conceived of as consumption plus change in net worth between two points of time that are infinitesimally close.[18] The delay between collecting tax immediately and waiting until the end of the year is a collection lag. The effect of inflation on tax base measurement arises because in order to ascertain the change in net worth, one must subtract net worth at the beginning of the period from net worth at the end of the period.[19] When there is inflation, this exercise should be performed by adjusting the beginning value for the inflation that has occurred during the period. To do so is central to the motivation for the income tax base. The base measures how much the taxpayer could have consumed during the period without altering the value of his or her wealth. A merely nominal increase in wealth should not be counted as giving rise to consumption potential. Only a change in wealth above and beyond inflation can be consumed while leaving the taxpayer's stock of wealth unchanged in real terms.[20]

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[18]The rationale for this is spelled out in Victor Thuronyi, *The Concept of Income*, 46 Tax L. Rev. 45, 65–68 (1990); *see also* Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 Yale L. J. 1817 (1990).

[19]The effect of inflation on the measurement of taxable income was recognized by Simons, but he considered that "any attempt to allow systematically for monetary instability in the measurement of taxable income seems altogether inexpedient." Henry C. Simons, Personal Income Taxation 206 (1938).

[20]To convert the value of beginning wealth expressed in beginning-of-the-period currency into end-of-the-period currency, some index must be used. If there has been no change in relative prices, all indices will be the same. Absent this assumption, the choice of index will make a difference. Use of a consumer price index (CPI) is appropriate because it looks at the value of the currency from the point of view of an individual consumer, which makes sense because the income tax is based on considerations of equity between individuals. This is also true of the tax on income of entities, because the owners of entities are individuals. The CPI will only be accurate for the average consumer whose consumption pattern matches the assumptions of the index. Other consumers will assign a different value to the national currency, based on their consumption patterns. Because it does not reflect changes in consumption patterns resulting from relative price changes, the CPI as usually constructed may overstate inflation. *See* Mark A. Wynne & Fiona D. Sigalla, *The Consumer Price Index*, Economic Review, Federal Reserve Bank of Dallas 1 (Second Quarter 1994). *See also* Vincent Koen, *Price Measurement and Mismeasurement in Central Asia*, IMF Working Paper (WP/95/82 Aug. 1995). Although this problem of choice of index is not peculiar to inflationary conditions, it tends to be aggravated under such conditions, particularly when the inflation rate is very high, because under these circumstances relative prices tend to change more dramatically than when the general price level is fairly stable. Conceptually, however, the index number problem is of the same nature as the problem of using national currency to measure income where the general (average) price level is stable, given differences in consumer preferences and changes in relative prices. The extent to which the CPI overstates inflation and, hence, may be an inappropriate index to use without adjustment, is beyond the scope of this chapter. I will assume for purposes of this chapter that appropriate adjustments are made so that there is no such overstatement.

D. Reason for Categorization

In one sense, it can be said that inflation has only one effect on taxation, as on anything else, which is to erode values expressed in units of national currency. The above categories are therefore all subcategories of this one effect. What distinguishes them is not so much mathematical logic as it is the practicalities of how taxes work. It is helpful to distinguish among these categories in order to understand the effects of inflation on taxation in a concrete and practical way and in order to formulate workable solutions to counteract these effects. For example, one often hears complaints that inflation causes people to be taxed at higher and higher marginal rates (so-called bracket creep). It may seem, therefore, that this is a problem with the rates and that the remedy is to reduce the rates. In fact, it is a problem of the rate brackets being stated in terms of national currency, and the remedy to exactly compensate for this effect would be to adjust for inflation the levels defining the rate brackets, not to adjust the tax rates. In another example, if, as with a VAT under which there are no tax credit carryovers (i.e., where any excess credits are refunded immediately), the only effect of inflation arises from the erosion of the tax obligation (collection lag), then a practical remedy to reduce the effect of inflation would be to shorten the collection lag.

II. Adjustment of Taxes Other Than Income Tax

Inflation adjustment of taxes other than the income tax is straightforward and need not be discussed here in detail. In the case of the VAT, for example, there is not much of a problem, even at high inflation rates, given that the tax is usually collected every month. In a credit-method VAT, the tax base is sales minus purchases taking place during the month. If inflation is high, one might want to index the tax liability for inflation taking place between the occurrence of the taxable event and the payment of tax. If tax is due on the fifteenth of the following month, it would be appropriate to adjust tax liability for one month's worth of inflation, assuming that the average sale and the average purchase take place in the middle of the month. If inflation is really high (more than, say, 20 percent a month), one could require taxpayers to account for sales and purchases weekly or even daily, adjusting each amount for inflation. Of course, this would complicate administration of the tax and may be impracticable. If the VAT law does not allow an immediate refund of excess credits, but instead requires them to be carried over, the carryover needs to be adjusted to maintain the value of this obligation owed by the government to the taxpayer.

The personal consumption tax is not in operation in any country, but has been the subject of academic discussion. This tax can take several forms;

here the form discussed by Graetz is assumed;[21] taxable consumption for a year equals total receipts minus total amounts invested. Such a tax does away with the need to ascertain the cost of particular assets and the time when gains are realized for tax purposes. It might seem, therefore, that no inflation adjustment is required, because there are no cost recovery deductions based on historic values. There remains, however, the problem of intrayear timing. Consider a simple example. Two taxpayers each receive $100 in cash, which they immediately spend. The only difference is that one taxpayer receives this amount earlier in the year. The tax base for each will be $100. However, the taxpayer who receives the amount earlier is able to purchase more valuable goods than the person who receives the same nominal amount later in the year. These problems can be dealt with by calculating the tax base on a monthly basis (or more frequently, if there is significant monthly inflation) and adjusting the tax liability for each month to the time of payment.

III. Adjustment of Income Tax

A. General Issues

The effect of inflation on the income tax is complex because it consists of a combination of the three effects described above. First, inflation erodes amounts expressed in national currency in the statute, most important, the tax brackets and personal deductions. Second, there is a collection lag, being the difference between the time income is received and the time the tax is paid. Third, the tax base is distorted, because inflation erodes the historic cost of the taxpayer's assets and liabilities.

Costs of acquiring property are accounted for in historic terms. The determination of income from property requires accounting for the cost of the property and allowing the taxpayer to recover this cost. Accounting for the cost in historic terms erodes the value of the cost recovery and overstates the tax base. For example, if property is sold, calculating the gain by subtracting the acquisition cost (measured in historic terms) from the sales price (measured in current units) will inflate the amount of the gain. In the case of depreciation, the amount of depreciation is understated if it is measured on the basis of historic cost. In the case of holding cash, there is no sales event, but cash held at the end of the period will have a lesser value than its historic cost stated at the closing price level, so that there is a loss in inflation-adjusted terms, but no loss if historic cost is used.

In the case of liabilities, inflation distorts the treatment of interest paid on debt. In fact, interest should be divided into two components: real interest and compensation for inflation. The latter is really not interest at all, but is re-

[21]*See* Michael Graetz, *Implementing a Progressive Consumption Tax*, 92 Harv. L. Rev. 1575 (1979).

payment of a part of the principal of the loan.[22] Thus, the inflation adjustment of loans requires the inflationary component of interest to be subtracted in determining interest income and expense.

If the tax base is not adjusted for inflation, substantial over- or undertaxation can occur. The overall revenue effect of inflation on the tax base depends on a number of factors. Inflation can increase the tax base (this is particularly likely to happen if the scope for deducting interest expense is limited). In the absence of limitations on the deduction of nominal interest, inflation can erode the tax base, particularly if there is free access to credit and if much interest income escapes taxation, as taxpayers arrange their affairs so as to eliminate instances of overtaxation, and maximize opportunities for undertaxation.[23] On a more abstract level, inflation can be seen as destroying the integrity of all forms of accounting, including tax accounting, based on historic costs. Inflation makes it impossible to add or subtract amounts such as receipts, expenses, inventory balances, and so on, stated at historic costs and occurring on different dates. It is as if these numbers were expressed in different currencies. At high levels of inflation, the tax base becomes virtually meaningless.

So much is common knowledge. What is not so commonly understood is precisely how the income tax base should be adjusted for inflation and whether inflation adjustment is feasible in the actual administration of an income tax. These points are explored below.

The method of adjustment for inflation must be tailored to the methods of accounting that are used under the income tax. In general, one would not want to allow a deduction for an inflation adjustment before the associated inflationary component of income is taken into account in determining taxable income. For example, if an asset is purchased at the beginning of year 1 and is sold at the end of year 5, at which time the gain is taxed, a deduction for the inflationary component of the gain should be allowed only in year 5.

If the asset is financed through debt, and if the interest expense incurred to finance the asset is currently deductible in years 1 through 5, it would be appropriate to adjust the interest deduction for inflation on an annual basis as well, that is, to deny a deduction for the portion of the debt that represents am-

[22]The repayment of principal occurs because inflation reduces the real value of the debt. If the value of the debt has gone down, it must be because part of the debt has been repaid. Strictly speaking, under this analysis, the portion of the "interest" payment that should be regarded as repayment of principal should be determined with reference to the anticipated rate of inflation; if the actual rate differs from the anticipated rate, there will be a gain or a loss on the contract to either the debtor or the lender. Thus, there are three elements involved in what is nominally designated as interest expense: (1) interest, (2) repayment of principal, to the extent that the principal is eroded by inflation that was expected by the parties, and (3) to the extent that inflation is less than expected, a payment by the borrower to the lender reflecting the lender "winning the bet" on what inflation would be (the opposite if inflation is greater than expected).

[23]*See* Efraim Sadka, *An Inflation-Proof Tax System?* 38 IMF Staff Papers 135, 140–41 (1991).

ortization of principal.[24] If, however, deduction of the interest expense is deferred until the asset is sold, then it would also be appropriate to defer the inflation adjustment of the interest expense.[25]

The general implication is that there is no unique, technically "correct" way of adjusting the income tax for inflation. The design of inflation adjustment rules appropriate for a particular country's income tax should be consistent with (1) the expected inflation rates in the country; (2) the rules for determining taxable income, particularly rules relating to the timing of income and deductions; (3) the ability of taxpayers and administrators to apply inflation adjustment rules of different degrees of complexity and the administrative and compliance costs of various alternatives; (4) revenue needs; and (5) transitional and other political accommodations required.

In general, one can classify inflation adjustment methods into three groups:[26] (1) ad hoc adjustment, which is an attempt to eliminate the effect of inflation wholly or partly on particular items, but which is not explicitly based on the current rate of inflation; (2) partial adjustment, which involves explicit inflation adjustment of particular items; and (3) global adjustment, which is a comprehensive adjustment to the taxpayer's accounts and is generally based on the accounting balance sheet.

B. Ad Hoc Adjustment

Ad hoc adjustment is effected through measures that are not explicitly based on calculating the amount of inflation, but that are designed to offset the effects of inflation on particular transactions. Examples are applying a lower rate of tax on capital income, accelerated depreciation, a partial exclusion for capital gains, last-in-first-out (LIFO) inventory accounting, and limitations on the deduction of interest expense or inclusion of interest income. Reducing the length of collection lags is also an ad hoc adjustment. This can be done by speeding up requirements for advance payments, accelerating the due date for final payment, or imposing withholding taxes.

None of these measures is based on the actual rate of inflation for the year. Depending on how they are structured, they may offset the effects of inflation with greater or less accuracy. Most also have other justifications. For

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[24]*See supra* note 22.

[25]In general, where the inflation adjustment mechanism involves subtracting debt from the opening balance, an adjustment would have to be made for interest expense that is not currently deductible. Inflation adjustment based on the opening balance is the general approach of countries that use "global adjustment." *See infra* sec. III(D).

[26]For those readers who wish to compare the treatment here with that in Charles E. McLure, Jr. et al., The Taxation of Income from Business and Capital in Colombia, ch. 7 (1990), the term in the McLure book "integrated adjustment" corresponds here to "global adjustment," and "ad hoc adjustment" corresponds here to "partial adjustment." That is, McLure uses two terms, while this book uses three.

example, both accelerated depreciation and preferential treatment of capital gains have been supported on grounds that have nothing to do with inflation, but have also been justified as ad hoc responses to inflation.

The realization rules of the income tax can also act as an ad hoc offset to inflation. At certain holding periods and inflation rates, the benefit to the taxpayer of being able to defer taxation of the gain until realization roughly offsets the detriment of having to pay tax on the inflationary component of the gain.[27]

Some countries with high inflation rates have required enterprise income tax to be calculated and tax to be paid on a quarterly or monthly basis.[28] In a rough way, this has the effect of protecting the tax base from inflation. It is reasonably accurate, for example, for service businesses, where capital is not a material income-producing factor. It does not, however, deal with problems such as the erosion in value of fixed assets or the inflationary component of interest income or expense.

Depending on how they are designed, ad hoc methods compensate for inflation to varying degrees. If the inflation rate is stable and fairly low, it is possible to largely offset the effects of inflation on taxable income by playing around with such adjustments. Ad hoc adjustments can be relatively simple because they do not require explicit calculation of inflation. In general, however, ad hoc adjustments are problematic because they are not completely accurate and, moreover, will retain their accuracy at only one rate of inflation. If the rate of inflation varies, ad hoc approaches will end up over- or undercompensating. Ad hoc adjustments cannot hold the system together if the inflation rate is high or variable.[29] Moreover, some types of ad hoc adjustments do not work accurately even if inflation stays the same. Thus, for example, excluding one-half of nominal capital gains from tax will only by coincidence correspond to the inflationary portion of the gain (not to mention problems that arise from the deferral of tax and the leveraged financing of capital assets).

C. Partial Adjustment

Partial adjustment involves adjusting for inflation with respect to particular items of income or deduction, usually by indexing the cost of the capital involved. Most countries that adopt some form of inflation adjustment employ partial or ad hoc adjustments. Because these can take a countless variety of

[27]*See* C. Eugene Steuerle, Taxes, Loans, and Inflation (1985); R.J. Vann & D.A. Dixon, Measuring Income Under Inflation 81 (1990).

[28]*See, e.g.*, Lege privind impozitul pe profit, art. 3, Monitorul Oficial, Jan. 31, 1991 (Romania, profit tax law—repealed 1994); Law of the Kazakh Soviet Socialist Republic of February 14, 1991, Concerning Taxes on Enterprises, Associations and Organizations, art. 8 (repealed 1995)(quarterly calculation of income and payment of tax).

[29]*See* Yishai Beer, *Taxation Under Conditions of Inflation: The Israeli Experience*, 5 Tax Notes Int'l 299 (1992).

forms and because their design depends heavily on the specific features of the income tax law of the particular country, this chapter does not discuss in detail the problems involved. Instead, it focuses on global adjustment, because the relevant rules provide a conceptual framework within which partial and ad hoc adjustments can be evaluated.

Partial adjustments adopted by various countries include, for example, explicit indexation of the basis of depreciable property and indexation of the basis of property in computing capital gains.[30] Interest income or expense may also be adjusted for inflation. Another possibility is a onetime revaluation of the balance sheet, thereby allowing depreciation and capital gains to be computed on the basis of an indexed cost.[31]

Unless they are rather comprehensively applied (perhaps in combination with ad hoc methods), partial methods are dangerous because they can exacerbate imbalances in the system.[32] For example, if the only adjustment for inflation consists in indexing the basis of capital assets, then a preference for investment in such assets is created; financing of such investments through debt is encouraged; and an unfair preference is created.

Partial adjustments are complicated because the balances of assets or debts involved can fluctuate from day to day. For example, the balance of a loan (or of a bank account) can change from day to day, so that an accurate determination of the partial adjustment would require computing the inflation adjustment for each day. A similar problem occurs with inventory. Further, the acquisition cost of an asset may be incurred over a number of different transactions. Shares, for example, can represent reinvested amounts of dividends, which might be received each month over a number of years. Indexing the cost of the shares would require a separate calculation for each of these transactions. And some assets represent improvements that are incurred frequently.

[30]*See* Finance Act 1982, secs. 86–87 (U.K.); J. Andrew Hoerner, *Indexing the Tax System for Inflation: Lessons from the British and Chilean Experiences*, 2 Tax Notes International 552 (1990) (indexation of capital gains); AUS ITAA §§ 160ZH, 160ZJ (indexing of capital gains); Tanzi, *supra* note 1.

[31]*See* Ruppe, *supra* note 3, at 105. Such a revaluation has been permitted twice in France. The upward valuation of assets was tax free, but a low level of tax was imposed on distributions made out of the revaluation reserve. *See* Pierre Beltrame, L'imposition des revenus 120–22 (1970); Loi No. 59-1472 du 28 déc. 1959 portant réforme du contentieux fiscal et divers aménagements fiscaux, J.O. Dec. 29, 1959, art. 39 (FRA); FRA CGI art. 238 *bis* I, 238 *bis* J. Such a revaluation of the balance sheet clearly does not attempt to properly measure the income of an inflationary period, but it leads to a more realistic measurement of income for a period of stable prices following inflation. Paradoxically, therefore, the only time this inflation adjustment method may be justified is when inflation has ceased. The approach is also defective because it corrects for inflation in favor of the taxpayer, but not in favor of the fisc.

Japan allowed several write-ups of the value of fixed assets in the 1950s. *See* Mitsuo Sato, *National Report—Japan*, LXIIa Cahiers de droit fiscal international 411, 413 (1977).

[32]*See* New York State Bar Association Tax Section, *Report on Inflation Adjustments to the Basis of Capital Assets*, 48 Tax Notes 759 (1990); *see also* vol. 2, ch. 16.

If carefully implemented, partial methods can work as long as inflation remains moderate. At significant inflation rates, partial methods become problematic, so that they must either be extended to everything or replaced by an explicitly global method.

If partial adjustment is applied broadly enough, the result can begin to resemble global adjustment. Conceptually, it is possible to approach inflation adjustment from the point of view of removing the effects of inflation on each transaction that goes into the determination of tax liability—a partial approach applied comprehensively.[33] But the difficulty of this approach is that it requires inflation adjustment of countless transactions. Even a simplified approach would require taking inventory at frequent intervals, such as monthly, which may be commercially impracticable.[34] The only feasible way of accounting for each transaction in terms of inflation-adjusted units is to keep accounts in currency of constant purchasing power.[35]

D. Global Adjustment

1. *General Issues*

Global adjustment refers to a method for comprehensively removing the effects of inflation on the tax obligation as well as the effects on the tax base.[36] Global adjustment restates taxable income in terms of the price level prevailing at the close of the year. Global adjustment is based on adjusting items in

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[33]This is, for example, the general approach of Vann & Dixon, *supra* note 27. John Bossons, *Indexing for Inflation and the Interest Deduction*, 30 Wayne L. Rev. 945, 960–61 (1984), takes a similar approach, calling for the indexing of the cost of all assets. *See also* Reed Shuldiner, *Indexing the Tax Code*, 48 Tax L. Rev. 537 (1993). However, no country has adopted such a "comprehensive partial" approach.

[34]*See* Vann & Dixon, *supra* note 27, at 90–99.

[35]*See infra* sec. III(D)(4).

[36]Previous discussions (in English) of global adjustment include McLure et al., *supra* note 26, at 189–273; Milka Casanegra de Jantscher, *Chile*, *in* Adjustments for Tax Purposes in Highly Inflationary Economies (proceedings of a seminar held in Buenos Aires in 1984 during the 38th Congress of the International Fiscal Association); Arnold C. Harberger, *Comments*, *in* Aaron et al., *supra* note 17, at 380.

Similar methods of inflation adjustment are often used for accounting purposes in countries with high inflation rates. *See, e.g.*, International Accounting Standards Committee, *International Accounting Standard 29, Financial Reporting in Hyperinflationary Economies in* International Accounting Standards 1995, at 497 (1995). IAS 29 appears to reach approximately the same result as the global adjustment method described in this chapter, but the means of getting to that answer seems to be more complicated, in that "all amounts [in the income statement] need to be restated by applying the change in the general price index from the dates when the items of income and expenses were initially recorded in the financial statements" and, in addition, the "gain or loss on the net monetary position is included in net income." *Id.* at 506. The latter "may be estimated by applying the change in a general price index to the weighted average for the period of the difference between monetary assets and monetary liabilities." *Id.*

the taxpayer's opening and closing balance sheet, rather than on particular items of income or deduction. Because it is based on a balance sheet, it can be applied only to taxpayers who account for their income using double-entry bookkeeping.

The elegance of global adjustment is that it achieves the same effect as adjusting each transaction for inflation during the year, but accomplishes this result by relying mainly on the opening and closing balance sheet. It requires adjusting only a selected number of the transactions that take place during the year, which are much easier to keep track of than movements of inventory and items of income and expense generally.

Global adjustment has been practiced for some time in countries that have suffered from chronic high inflation.[37] The method of global adjustment discussed below is based on the rules applicable in Chile, which have been in force since 1974. The rules in other Latin American countries with global adjustment are broadly similar.[38] In 1994, Romania adopted global adjustment for its profit tax.[39]

Because it is based on the balance sheet, global adjustment is easiest to understand as part of the net worth method of determining taxable business income.[40] In simplified terms, this method determines the taxable income of a business as the difference between the taxpayer's net worth at the end of the year and its net worth at the beginning of the year, with some adjustments. The method is described briefly below and in greater detail in chapter 16 of volume 2.

In an inflationary environment, all the elements of the net worth calculation must be adjusted for inflation. The global adjustment does this by restating each element of the net worth calculation in end-of-the-year prices. In very general terms, therefore, the global adjustment works because the net worth calculation works. This is not to say that the global adjustment method can be introduced in an income tax only if income is determined on the basis of a net worth calculation—it is easy to specify the global adjustments to an income tax that determines taxable income as the difference between income and expenses;[41] indeed, Chile itself uses the income-less-expenses method, rather than the net worth method, in defining taxable income.[42] The main requirement to apply the global adjustment is the drawing up of an annual balance sheet. When taxable income is determined as the difference between gross income and expenses, the global adjustment can be expressed as a series of additions to and subtractions from taxable income.

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[37]The countries employing global adjustment include Argentina, Brazil, Chile, Colombia, Israel, Mexico, Peru, and Venezuela.

[38]*See, e.g.*, VEN IR arts. 90–113; COL ET arts. 329–55.

[39]*See* ROM PT art. 5. The inflation adjustment became effective in 1995.

[40]*See* vol. 2, ch. 16, appendix.

[41]*See* Appendix B.

[42]*See* CHL IR art. 31.

2. Global Adjustment in the Context of the Net Worth Method

This section explains a set of rules for global inflation adjustment in the context of an income tax that uses the net worth method to determine taxable income. These rules are closely modeled on those of Chile, although they are not identical to the Chilean rules in all respects. Alternatives to some of the rules described in this section are discussed in section 3 and in Appendix A. Appendix A consists of a more detailed statement of the global adjustment, in the form of illustrative statutory language and commentary.

A. Summary Explanation

The global inflation adjustment rules apply to enterprises that prepare, or are required to prepare, financial statements in accordance with accounting or commercial law (accounting balance sheet). The businesses that are required to do this are (in civil law countries) usually specified in the commercial code and may be both legal persons and physical persons.

The net worth method uses the net worth (assets minus liabilities) in the opening and closing balance sheets for the taxable year. The closing balance sheet is based on the accounting balance sheet and reflects both the assets and liabilities of the taxpayer at the close of the taxable year. The opening balance sheet for the taxable year is the same as the previous year's closing balance sheet. The values of items included in the closing balance sheet are adjusted for inflation taking place during the year.

Under the net worth method, taxable income is determined as the difference between closing net worth and opening net worth. It is also, however, necessary to subtract those items that increase closing net worth but that should not be included in taxable income, and to add items that decrease closing net worth but that should not be deductible in determining taxable income.

Accordingly, taxable income for the year is

	(i)	the amount of net worth reflected in the closing balance sheet,
less	(ii)	the inflation-adjusted amount of net worth reflected in the opening balance sheet,
less	(iii)	inflation-adjusted contributions to capital and inflation-adjusted incomes that are not taxable,
plus	(iv)	inflation-adjusted withdrawals made in favor of the owners and inflation-adjusted expenses that are not deductible.

Example

The opening balance sheet of an enterprise consists solely of 100 units of inventory purchased at $10 each. The firm has no other assets or debt. The CPI for the preceding December is 100. On July 1 (CPI for June is 200), the enterprise sells its inventory for $2,500 and invests the proceeds in a bank deposit that earns $2,500 to the close of the year. As of December, the CPI has risen to 400. The closing balance consists of $5,000 in cash.

Taxable profit is calculated as follows:

Closing net worth,	$5,000
Less inflation-adjusted opening net worth	$4,000
Equals taxable profit	$1,000

B. Adjustment of Opening Net Worth

The amount of opening net worth is adjusted for inflation for the taxable year. The amount of opening net worth is the value of total assets in the opening balance less the value of total debts and reserves in the opening balance. The reserves taken into account for this purpose are only those for which a deduction is allowed for income tax purposes. The opening balance is the same as the closing balance for the previous taxable period. See paragraph (J) below for rules on what is included in the balance. See paragraph (K) below for rules on how to determine inflation for the taxable period.

The inflation-adjusted opening net worth is subtracted in determining taxable income (item (ii) of the formula in paragraph (A) above). In the event that the opening net worth is negative (i.e., debts exceed the book value of assets), this operation results in an increase in taxable income, because a negative number is being subtracted.

C. Adjustment of Increases in Net Worth

Transactions that increase net worth, described below, are adjusted for inflation occurring between the month in which the transaction takes place and the close of the taxable period. The total inflation-adjusted amount of these transactions is subtracted in determining taxable income (item (iii) in the formula in paragraph (A) above).

These transactions consist of contributions to capital and nontaxable income. Contributions to capital are amounts contributed to the capital of the enterprise by its owner or owners.[43] Nontaxable income is any receipt of the enterprise that is not included in determining taxable income.

D. Adjustment of Decreases in Net Worth

Transactions that result in a decrease in net worth, described below, are adjusted for inflation occurring between the month in which the transaction takes place and the close of the taxable period. The total inflation-adjusted amount of these transactions is added in determining taxable income (item (iv) in the formula in paragraph (A) above).

These transactions consist of distributions and nondeductible expenses. Distributions are dividends, any other withdrawals of property from the enterprise by its owner or owners, and distributions in liquidation of the enterprise. Nondeductible expenses are expenses of the enterprise that are not allowed as

[43]As well as amounts contributed by nonowners if these amounts are considered nontaxable contributions to capital under the country's income tax law. *See* vol. 2, ch. 19.

deductions in determining taxable income, except for expenses that are added to the capital account of property.

E. VALUATION OF ITEMS IN CLOSING BALANCE

The value of items in the closing balance is adjusted for inflation as provided in paragraphs (F) through (I) below. The closing net worth is determined according to this adjusted balance sheet (item (I) in the formula in paragraph (A) above).

F. VALUATION OF DEPRECIABLE PROPERTY

Assume that the value of depreciable property in the closing balance is determined according to the pooling method,[44] except for property (such as immovable property) that is valued separately for each asset. Under such a system, depreciation for the year is calculated as a percentage of the pre-depreciation balance for each class of assets. This is equal to the opening balance[45]

(i) adjusted for inflation for the taxable year;
(ii) increased by the cost of any property in that class placed in service during the year, adjusted for inflation between the month in which the property is placed in service and the end of the year; and
(iii) reduced by the proceeds of disposition of any property disposed of during the year, adjusted for inflation between the month of the disposition and the end of the year.

G. VALUATION OF INVENTORY

The purpose of the inventory valuation rules is to come up with a value that will approximate prevailing prices as of the end of the year while following rules of thumb that are easily administered.

Goods of a particular type are valued at the cost of the item of that type that has the highest nominal cost, adjusted according to the percentage change in the CPI between the month in which the item was acquired and the end of the taxable year. Where there is significant inflation, the item in question will usually be the last-acquired item.

When none of a particular type of goods has been acquired in the taxable year, the goods are valued at their opening balance value, adjusted according to the percentage change in the CPI for the taxable year.

Elements included in closing inventory that are produced, rather than purchased, including work in progress, are valued according to the same principles, in relation to the costs incurred in their production. When costs of pro-

[44]*See* vol. 2, ch. 17.

[45]The opening balance is determined as the closing balance for the preceding year, which takes into account depreciation for that year.

ducing an item of property are incurred in more than one month, each month's costs are adjusted according to the percentage change in the CPI between that month and the end of the taxable year. However, depreciation or amortization of intangibles that is included in production costs is not adjusted because it is already calculated in prices prevailing at the end of the year. When the inventory consists of both finished goods and work in progress of the same type, the work in progress may be valued as a proportion of the value of the finished goods.

H. Valuation of Foreign Currency Items

Holdings of foreign currency, debt claims or other securities denominated in foreign currency, and debts denominated in foreign currency are adjusted in accordance with prevailing exchange rates as of the end of the year.

I. Valuation of Other Items in Closing Balance

The value of other assets included in the closing balance is adjusted for inflation between the month the asset was acquired and the close of the year or, in the case of assets that are included in the opening balance, for inflation occurring during the taxable year. Assets whose value is fixed in terms of national currency are not adjusted (e.g., cash, debt instruments). Liabilities are adjusted as well. Thus, liabilities denominated in foreign currency or those with an adjustment clause would be adjusted, while those denominated in national currency would not be adjusted.

J. Items to Be Included in Balance

The balance sheet used for inflation adjustment is based on the accounting balance sheet, adjusted as necessary for tax purposes. For an enterprise owned by an individual, only the assets and debts of the enterprise are included in the balance sheet (i.e., not the personal assets and debts of the individual).

The assets included in the balance sheet are only those that have a value for tax purposes and are effectively owned by the taxpayer. Thus, for example, assets leased to the taxpayer under a finance lease[46] are included in the taxpayer's balance sheet because they are effectively owned by the taxpayer even though they are nominally owned by the lessor. The balance sheet does not include entries on the financial balance sheet that represent nominal, transitory, or pro forma values that do not constitute an effective investment. Nominal assets might include, for example, assets on the financial balance sheet such as know-how, trademarks, patents, and concessions that do not reflect

[46] I presume that the law sets forth rules describing the circumstances under which a lease will be treated as a finance lease as opposed to an operating lease. *E.g.*, KAZ TC art. 43. *See generally* International Fiscal Association, *Taxation of Cross-Border Leasing*, 75a Cahiers de droit fiscal international (1990). Assets leased under an operating lease would be included in the nominal owner's balance sheet.

capitalized costs incurred by the taxpayer. Pro forma accounts reflect responsibilities or other information for the financial accounting of the enterprise (e.g., shares under guaranty, endorsed bills, or discounted bills).

K. Measurement of Inflation

Inflation is determined according to the officially published CPI, which typically reflects prices as of the end of a particular month and is published early in the following month. To adjust opening net equity to the end of the year, it is therefore appropriate to use the index for December. Thus, inflation for 1996 is determined according to the change in the index between December 1995 and December 1996. Transactions occurring during a particular month that need to be adjusted to the end of the year are appropriately adjusted using a mid-month convention that assumes that, on average, transactions occur in the middle of the month. Thus, a transaction occurring in November 1996 that needs to be adjusted to the end of the year is adjusted according to the percentage change between the average of the CPI for October 1996 and November 1996 and the CPI for December 1996 (reflecting 1½ months of inflation).[47]

L. Adjustment of Advance Payments, Tax Liability, and Loss Carryovers

The above-described inflation-adjustment rules result in a measurement of taxable income in prices prevailing at the end of the taxable year. The amount of tax due is adjusted for inflation between the end of the year and the time of tax payment. Advance payments of tax that are credited against the tax liability are adjusted from the date they are due until this same time. (If an advance payment is paid late, the taxpayer is liable for a penalty.)

Losses that are carried over from one year to the next are also adjusted for inflation. Thus, a loss of $1,000 for 1995 that is deducted against taxable income for 1996 should be adjusted according to the change in the CPI between December 1995 and December 1996.

M. Effect of Global Adjustment on Deduction for Interest Expense

The use of debt finance reduces the opening net worth by the nominal amount of the debt, and the closing net worth by the nominal amount of the debt plus accrued interest on the debt. The effect of global adjustment is that, in determining taxable income, the *inflation-adjusted* amount of opening net worth is subtracted. Because the debt decreases the opening net worth, the effect of the inflation adjustment is to increase taxable income by the amount of

[47]For example, suppose that a dividend of $500 is paid in November. Suppose that the CPI is 105 for October, 115 for November, and 121 for December. The average of the October and November indices is therefore 110, so that the applicable correction factor is 10 percent (121/110). Therefore, the adjusted amount of the dividend is $550.

the debt, multiplied by the rate of inflation. This has the effect of denying a deduction for the inflationary component of interest expense. For example, consider the simple case where the taxpayer starts the year off with zero assets and a debt of $11,000,000. The closing balance is a debt of $22,500,000, representing the initial debt plus accrued interest of $11,500,000 (suppose there is 100 percent inflation, so that this amount of interest is reasonable). Under an unadjusted system, the taxpayer has a loss of $11,500,000, representing the deduction for interest expense. Under global adjustment, taxable income equals closing net worth (–$22.5 million) minus inflation-adjusted opening net worth (–$22 million), that is, a loss of $500,000. One would obtain the same result from denying a deduction for the inflationary component of interest expense.

3. *Alternative Approaches*

Under global adjustment, the elements of the closing balance are valued in prices prevailing at the end of the year. However, there is more than one way of doing this. One approach is to try to value property at its fair market value. Another approach is to value the property at book value (usually based on acquisition cost), adjusted for inflation occurring since the last valuation (i.e., inflation occurring since the date of the opening balance sheet or since the property was acquired, if acquired during the course of the year). Strictly speaking, only the second method—valuing property at its acquisition cost plus inflation—is "pure" inflation adjustment. Valuation at fair market value involves not only inflation adjustment, but also the taxation of gains or losses attributable to changes in relative prices. If the fair market value is used for the closing balance sheet, then these gains and losses are taxed, even if they are not realized. This approach may seem desirable to some and undesirable to others.

Some argue that if one is designing inflation-adjustment rules, market valuation should not be employed because this goes beyond inflation adjustment.[48] If, however, the mandate is to design sensible income tax rules, regardless of whether they are called inflation adjustment, then it is necessary to decide on the merits whether inflation adjustment of the book value or a valuation that approximates fair market value is more desirable. This inquiry must be made separately for each type of asset.

Consider foreign currency. It is most straightforward to value foreign currency included in the closing balance at the exchange rate prevailing at the end of the year. It would, of course, be possible to instead adjust for inflation the acquisition cost of the particular currency. This would require one to keep track of the acquisition dates of foreign currency that is included in the closing balance. If acquired during the taxable year, it would be valued according to

[48] *See, e.g.*, Harberger, *supra* note 36, at 383.

the change in the price index between the month of acquisition and the end of the year. If it was on hand at the beginning of the year, then it would be adjusted for the entire year's worth of inflation. For foreign currency, the mark-to-market rule is simpler than pure inflation adjustment. Moreover, valuation at the end-of-year exchange rate makes sense from a policy point of view because it leads to a more accurate reflection of the economic income from foreign-currency-denominated financial transactions.[49]

Instead of trying to devise a "pure" set of inflation-adjustment rules, it is better to think in terms of an "inflation-adjusted" system, that is, a set of valuation and accounting rules that, together with the other features of the income tax, ensures that the system is relatively impervious to inflation and is also administrable and desirable under general principles of tax policy. Indeed, it may make little sense to pick out particular rules, call them the inflation-adjustment rules, and evaluate their structure separately from the rest of the system. The entire set of rules for the income tax should be considered as a whole and evaluated under general principles of tax policy.

4. *Equivalence Between Net Worth Calculation and Accounting in Constant Currency*

Another way of comprehensively adjusting for inflation is to account for all transactions relevant to income tax in currency of constant value. This has the same effect as global adjustment. Accounting in constant currency means using an artificial currency determined by adjusting the national currency by the change in the CPI. It would be the same as accounting in foreign currency, assuming that the exchange rate for the foreign currency exactly corresponds to the CPI. Of course, this assumption will not hold, and so accounting in constant currency differs from accounting in foreign currency.

Constant currency accounting means that each transaction a taxpayer enters into is accounted for by converting it to constant currency at the exchange rate prevailing on the date of the transaction. In addition, every day the amount of cash held by the taxpayer throughout that day has to be determined, and the resulting loss from holding this cash is determined by subtracting its value in constant currency at the beginning of the day from its value at the end of the day. The books are kept in this constant currency. This means that depreciation, gains and losses, inventory accounting, and so forth are all accounted for in this constant currency, so that the determination of taxable income is not affected by inflation. At the end of the year, the taxable income determined in this constant currency is converted to national currency at the exchange rate prevailing at the end of the year.

A relatively simple example can illustrate the operation of the net worth method and its equivalence to accounting for each transaction in units of cur-

[49]*See* Vann & Dixon, *supra* note 27, at 71–72.

rency with constant purchasing power. The facts are set forth in Table 1. The company in question starts out with $1,100 in cash at the beginning of day 1. Each day, at the end of the day, it purchases inventory and sells inventory. The number of units bought and sold each day is set forth in columns 5 and 6, and the purchase and sales prices are set forth in columns 3 and 4. Total cash sales are in column 7 and inventory purchased is in column 8. The resulting cash flow is in column 9.

Taxable income is computed as follows on the basis of accounting in constant-value currency. Each transaction is recorded on the books in units of currency with constant value. The gain or loss from holding currency is also taken into account each day. The cost of goods sold is calculated on a first-in-first-out (FIFO) basis. As shown in columns 10 and 11, the units sold each day consist of items purchased on the preceding day and on the day itself. The cost of goods sold is accordingly given in column 12. This is derived by multiplying the number of units by their cost in constant currency. For example, for day 2, the nine units have a cost of $130 divided by the price index of 1.3 (i.e., $100 apiece), and the two units dating from day 1 have a cost of $110 divided by 1.1 (also, $100 apiece), for a total cost in constant currency of $1,100. Sales revenue is stated in constant currency in column 13 (i.e., each number in column 7 divided by the corresponding price index for that day). Sales profit (column 14) is sales (column 13) less the cost of goods sold (column 12). Column 15 shows the loss incurred from holding units of domestic currency, which is calculated by taking the amount of currency held during the day (the amount on hand at the beginning of the day), calculating its value in constant units at the end of the day, and subtracting its value in constant units at the beginning of the day. Adding columns 14 and 15 gives the total profit for each day (column 16). The total profit in constant currency for the four days is $15.78 ($29.98 at day 4 prices).

Table 2 shows the global adjustment/net worth method of calculating profit. The closing net worth consists of $1,320 in cash and four units of inventory. The inventory is valued on a FIFO basis (the units all happen to date from the last period, so their unit cost is $200). Total assets are therefore $2,120. The opening net worth is $1,100 (the company having started out with cash only), which is $2,090 at day 4 prices. The profit for the four-day period is determined by subtracting $2,090 from $2,120. Apart from a rounding error, this gives the same answer as that obtained in Table 1. The example illustrates that global adjustment gives the same result as keeping books in currency of constant value and requires far fewer calculations.

5. *Determination of Specific Types of Income*

Global adjustment is effective in determining the taxpayer's total taxable income. Things become more complicated if it is necessary to break income down into specific categories. The income tax law may, for example, contemplate special rules for capital gains, business income, or foreign-source income.

Table 1. Constant Currency Accounting

Day	1. Price Index, End of Day	2. Cash at End of Day	3. Purchase Price	4. Sales Price	5. Units Bought	6. Units Sold	7. Sales	8. Purchases
0	1	1,100						
1	1.1	1,000	110	125	10	8	1,000	1,100
2	1.3	1,350	130	150	10	11	1,650	1,300
3	1.4	800	135	160	10	5	800	1,350
4	1.9	1,320	200	210	10	12	2,520	2,000

Day	9. Cash Flow	10. Goods Sold, Bought This Period	11. Goods Sold, Bought Last Period	12. Total Cost of Goods Sold	13. Inflation-Adjusted Sales	14. Sales Profit	15. Currency Loss	16. Daily Profit
1	–100	8	0	800	909.09	109.09	–100	9.09
2	350	9	2	1,100	1,269.23	169.23	–139.86	29.37
3	–550	4	1	485.71	571.42	85.71	–74.17	11.53
4	520	6	6	1,210.15	1,326.31	116.16	–150.37	–34.21
							Total	**15.78**

Note: Numbers have been rounded to two decimal places.

Table 2. Global Method

Closing cash	1,320
Closing inventory	800
Closing net worth	2,120
Less opening net worth	2,090
Profit	30

Note: Numbers have been rounded to two decimal places.

To create separate categories in an inflation-adjusted system, one would in effect have to allocate the inflation adjustment among different categories of income. Unfortunately, this cannot be done by allocating on a pro rata basis. What would be required to distinguish foreign-source income, for example, from domestic-source income is to create two different balance sheets. One would reflect the assets and liabilities related to the earning of domestic-source income, and the other, those relating to foreign-source income. Inflation adjustment would be separately applied to each, and domestic-source and foreign-source income could be correspondingly determined by applying the net worth comparison to each balance sheet. In some cases, this approach would be problematic because some items can be related to both foreign-source and domestic-source income.

Although it is therefore possible to determine separate inflation-adjusted categories of income, it obviously involves considerable complexity. This suggests that it would be better under an inflation-adjusted system to minimize the number of separate categories or to come up with simpler rules to determine the breakdown. For example, in the case of the foreign tax credit, if the foreign-source income is determined in a foreign currency (assuming that the currency does not involve substantial inflation), one could calculate the foreign tax credit limitation according to the ratio of foreign tax paid and foreign-source income in the foreign currency. (The equivalence of inflation adjustment and income determination in a foreign currency is discussed below.) If the income tax is fairly clean, and involves a substantial degree of mark-to-market taxation, then it should be possible to largely do away with special rules for separate categories of income. Indeed, it may be necessary to do away with most such rules in order to feasibly operate a global adjustment system.

6. *Limitations on Expenses*

Closely related to problems involved where income is broken down into different types are problems having to do with limitations on expenses. In a world without inflation, it is not too difficult to provide limitations on various kinds of deductions, expressed in terms of either an amount of money or a percentage of income. In an inflationary situation, such limitations are difficult to

calculate, because expenses may be incurred at different times, so that the nominal amount of the expenses cannot simply be added up. What would be required is to itemize the expenses for each month, adjust these for inflation, and then compare them with the amount of the limitation.

Even more difficult is dealing with a limitation on the deduction for interest expense.[50] Because the global adjustment has the effect of denying a deduction for the inflationary element of interest expense, it would be incorrect to add up interest expense, compare it with the limit, and deny a deduction for the excess. What would be required is to calculate the amount of real interest expense and to subject only this amount to potential denial. This would require determining the average level of outstanding debt or, alternatively, a method of approximation.

While calculations such as these can be made, the message is that any limitation on deductions becomes substantially more complicated in the context of global inflation adjustment, so that if this method is to work properly, limitations should be kept to a minimum. This would not be true of limits based on a percentage of each expense. For example, if 75 percent of entertainment expense is denied, then the limitation is easy to determine because it applies to the amount of each expense. The amount of deduction denied in each month still has to be kept track of, however, because it is necessary to adjust each month's nondeductible expenses for inflation under the global method.[51]

E. Inflation Adjustment of Nonbusiness Income of Individuals

Countries employing global adjustment generally do not apply it to all taxpayers. Because it requires rather sophisticated accounting, global adjustment is restricted to taxpayers using double-entry bookkeeping. Although this would include some individuals with business income, the global adjustment is applied only to the assets and liabilities that are part of the business.

Various combinations of ad hoc and partial methods are applied in different countries to measure taxable income from capital of individuals (other than income subject to global adjustment). For example, in Argentina,[52] individuals may index for inflation the tax cost of property for purposes of computing gain on disposition and computing depreciation. Moreover, virtually all interest income of individuals is excluded from taxation. Part of the rationale for this exclusion was that it would be difficult to index interest income;[53] moreover, given the fact that historically interest rates had often been zero or negative in real terms, it was felt that taxation of interest in-

[50]*See* vol. 2, ch. 16.

[51]*See supra* Sec. III(D)(2)(d).

[52]The discussion in this paragraph reflects the law as of 1990.

[53]For example, the global adjustment does not attempt to separately identify the inflationary component of interest income.

come would be unnecessary. Interest expense is, however, fully deductible in Argentina if incurred in earning taxable income, and this has resulted in some anomalies, where the associated investment income is not fully taxed on a current basis.

Ad hoc or partial adjustments to the measurement of taxable income from capital of individuals may suffice in a country with moderate inflation. When inflation approaches annual levels of 100 percent or higher, though, there is the problem that an individual's income is computed on an annual basis, without adjustment for changes in the price level during the year. For example, a taxpayer who earns $100 at the beginning of the year and incurs a deductible expense of $100 at the end of the year pays no tax, even if the price level is much higher at the end of the year; the real value of the expense is therefore less than that of the income. A solution that has been adopted in Brazil is to require individuals to calculate their income and deductions on a monthly basis, and to index these amounts, together with amounts withheld and estimated tax payments made, for inflation occurring between the month in question and the end of the year. This system of monthly accounting works well for income from services, but the system would not suffice to adjust income from capital, because it does not index the tax cost of property. Combined with partial methods that provide such indexing, monthly accounting can provide an acceptable scheme for taxing individual income, the drawback being the administrative complexity involved in multiplying the number of accounting periods.

The monthly income of individuals does not need to be indexed to the extent that tax liability is satisfied by withholding. In many countries, taxpayers with income from wages have tax withheld currently and are not required to file a return at the end of the year.[54] Because the tax liability is satisfied currently, there is no need for inflation adjustment of the tax base. The amounts in the withholding tables that are stated in local currency (i.e., the brackets) must, however, be adjusted on a monthly basis, or even more frequently when inflation rates are very high. If there is over- or underwithholding, then monthly indexing of the over- or underwithheld amounts as described for Brazil would be necessary.

F. Collection of Tax

The above discussion of global adjustment implicitly assumes that tax is paid at the end of the year. In practice, however, the payment of tax is more complicated. First, the tax liability is generally due not at the end of the year, but at the time that the return for the year is due. Second, a considerable portion of income tax liability is satisfied during the year in the form of withholding and payments of estimated tax. The rules for indexing these advance

[54]See vol. 2, ch. 15.

payments of tax must be considered in conjunction with the inflation-adjustment rules analyzed above.

Amounts withheld should not be indexed if the corresponding income is not indexed. If, however, monthly indexing of income and expenses is adopted, then amounts withheld and estimated tax payments should also be indexed up to the end of the year, and the net amount due should be indexed from the end of the year until the date of payment.

In the case of companies (and sole proprietorships subject to global adjustment), given that global adjustment expresses the taxpayer's income in terms of the price level prevailing at the close of the taxable year, it is appropriate to adjust amounts withheld and estimated tax payments made for inflation occurring between the time the payment is made and the end of the year. The balance due (tax liability less these indexed amounts), or refund due, if there is a refund, should then be indexed to the time when the tax is paid or the refund is made.

Business losses and capital losses allowed as a carryforward deduction from previous years should also be indexed. In effect, these involve the taxpayer's claims for tax refunds against the government, the value of which should be maintained in real terms.

G. Foreign Currency Translation

An alternative way of looking at inflation adjustment is that it involves the same process as translating into domestic currency the income of a business that keeps its books in foreign currency. As shown above in section D(4), global adjustment is equivalent to keeping books in units of currency with constant purchasing power. The main difference between inflation adjustment and translation of accounts kept in foreign currency therefore lies in the index used to deflate domestic currency: the consumer price index versus the exchange rate.

The net worth/global adjustment method resembles the net worth method used to determine the income of a foreign branch, which has been in use in the United States since the 1920s.[55] Under the U.S. net worth method, the income of a foreign branch is determined as the difference between closing and opening net worth, with proper adjustment for profits distributed during the course of the year.[56] All of the terms of the formula are determined in foreign currency (assuming that the foreign branch keeps its books in foreign currency), but are then translated into U.S. dollars. Fixed assets are translated at the exchange rate prevailing at the time they were purchased. Current assets

[55]*See* Donald R. Ravenscroft, Taxation and Foreign Currency 85–87 (1973). I will call it the "U.S. net worth method."

[56]*See* Rev. Rul. 75-106, 1975-1 C.B. 31; Rev. Rul. 75-134, 1975-1 C.B. 33.

are translated at the exchange rate in effect at the close of the year. Distributed profits are translated at the exchange rate in effect at the time of distribution.

The purpose of the net worth method, which is to determine the income of the foreign branch or corporation in U.S. dollars, is exactly analogous to the purpose of determining the income of a domestic corporation in units of fixed purchasing power. In performing inflation adjustment, one is in effect translating one currency (nominal units of national currency) into another (currency of a fixed purchasing power); the "exchange rate" at any time is given by the CPI. The general problem, then, can be stated as one of determining in units of currency X the income of a business that keeps its books in currency Y. Properly applied, the net worth method of translation into U.S. dollars would have exactly the same effect as the global adjustment rules in a situation where there is no inflation in the United States and where exchange rate changes exactly mirror price level changes in the foreign country in which the branch operates.

This analogy reveals the defects in the net worth method as it was previously applied in the United States. The primary problem is that "current" assets (other than foreign currency and debt) are translated at the year-end exchange rate. Instead, under the inflation-adjustment rules set forth above, such assets (e.g., inventory) should either be translated at the exchange rate prevailing at the time of purchase, or marked to market in U.S. dollars at year-end. Valuing them at their foreign currency acquisition cost, translated at the year-end exchange rate, can result in a gross deviation between their true value and their value in the balance sheet. The problem has long been known.[57] What is remarkable is that it remained uncorrected for so long.

Recently, regulations have been issued providing a revised methodology for the net worth method, called the "United States dollar approximate separate transactions method of accounting" (DASTM).[58] The regulations provide for a rather convoluted calculation for determining the profits of foreign branches that keep their books in a hyperinflationary currency. Total income is determined according to a net worth calculation performed in U.S. dollars. In general, the items included in the balance sheet that is used to determine net worth are valued at the U.S. dollar exchange rate as of the time that the item was acquired.[59] Certain items denominated in the hyperinflationary currency are, however, valued at the year-end exchange rate (bad debt reserves, prepaid income or expenses, holdings of hyperinflationary currency, and hyperinflationary debt obligations and financial instruments). This is appropri-

[57]*See* Ravenscroft, *supra* note 55, at 278–79.

[58]*See* U.S. Treas. Reg. § 1.985-3. *See generally* Douglas Hassman et al., *A Practical Guide to Applying DASTM to the Current and Prior Taxable Years*, 10 Tax Notes Int'l 662 (1995); Charles Cope & Robert Katcher, *Final DASTM Regulations Provide Significant Advantages to Businesses Operating in Hyperinflationary Countries*, 9 Tax Notes Int'l 753 (1994).

[59]*See* U.S. Treas. Reg. § 1.985-3(d)(5).

ate for the same reason that items denominated in local currency are not indexed in applying global adjustment (see section D(2)(i) above). By contrast, other "current assets" are valued not at the year-end rate, as under the former net worth method, but rather at the rate obtaining at the time of acquisition. Therefore, the net worth method under Reg. sec. 1.985-3 should result in an appropriate measure of taxable income.

The regulation does not stop at measuring total income according to the net worth method. It also contemplates the translation of income and expenses of the branch (accounted for in foreign currency) into U.S. dollars at the exchange rate for the month in which the income and expenses are incurred. This is not exactly the same as keeping the books in U.S. dollars. For example, gains and losses with respect to foreign currency assets and liabilities are not taken into account under this calculation. The difference between this amount of income and the income determined according to the net worth method is called the "DASTM gain or loss" and, in order to determine the character of income for purposes of the foreign tax credit limitation, the controlled foreign corporations provisions (Subpart F), and the like, this amount is allocated to assets of the branch in a calculation (reminiscent of a Balkan line dance) called the "DASTM 9-step procedure."

The analogy between foreign currency translation and inflation adjustment suggests that another acceptable method of inflation adjustment in a hyperinflationary economy should be to keep books in U.S. dollars or another strong currency. (The year-end result would then be translated into local currency at the exchange rate prevailing at the end of the year.) If every transaction were accounted for in dollars rather than in local currency, the result would be the same as under global adjustment, except that the exchange rate may depreciate at a different rate from the inflation rate[60] and thereby lead to a substantially different result.[61] If this difference is considered acceptable as a matter of policy, and if there are business reasons for a company to keep its books in dollars, then dollar accounting could be authorized as an alternative mechanism of inflation adjustment. This approach may be complicated for many taxpayers because it requires every transaction to be converted into foreign currency. However, it would not be difficult for taxpayers who already keep their books this way for business reasons. Companies with substantial international operations may find it easier to keep books in one of the major currencies. Keeping foreign currency books is an alternative to inflation adjustment for limited categories of taxpayers in Israel.[62]

[60]Another difference is that, depending on how the global adjustment is structured, the closing balance may involve marking some items to market rather than adjusting them according to the price index.

[61]A more complex alternative would be to use a basket of currencies.

[62]*See* ISR IT art. 130A.

IV. Conclusion

In deciding what inflation adjustment methods to adopt, if any, their administrative costs for taxpayers and for the tax administration should be carefully considered.

For example, the global method of inflation adjustment can be adopted only for companies having access to well-trained accountants. A simplified version of the global method can be adopted if inflation rates are moderate. Partial adjustment can be more complicated than global adjustment, because it may require a greater number of calculations. Ad hoc adjustment requires no inflation calculation, and so is administratively the simplest to apply, although, as pointed out, it may involve serious distortions.

Collection lags can be dealt with by shortening the lag; this may require more compliance effort by taxpayers and tax administrators collecting the tax, for example, if more frequent tax payments are required. The collection lag problem can also be dealt with by adjusting tax payments for inflation up to the date of payment. This requires putting into place procedures for this calculation and complicates payment procedures. Such procedures may be required only at higher inflation rates. Similarly, advance payments can be adjusted for inflation, but this also involves additional complexity for taxpayers.

Only global adjustment can eliminate both effects of inflation on the income tax, that is, the erosion of tax obligations and the distortion of the tax base. Partial adjustment, although not a perfect solution, can, if comprehensively applied, eliminate the distortion of the tax base. It does not, however, deal with the collection lag problem because it is confined to adjusting the historic cost of assets and debts. But if inflation is relatively low (i.e., say, about 30 percent a year or less), the collection lag problem on average is not that significant for the income tax and partial adjustments can be reasonably accurate. Partial methods can, however, be problematic at such inflation rates if they are not comprehensively applied. Thus, if some elements of the tax base are adjusted and others are not, serious distortions can arise. Indeed, the total distortion can be worse than if there is no adjustment. For example, if the only adjustment is to the cost of assets for purposes of determining taxable gain and depreciation, while interest is not adjusted, then a severe incentive is created to finance assets with debt. This can easily lead to "negative tax rates";[63] that is, instead of collecting tax on the income from a certain asset, the tax rules actually create a tax loss, which can be used to shelter other income and reduce the taxpayer's tax liability.

It is therefore possible in principle to adjust the income tax fairly accurately for inflation. However, accurate adjustment can involve considerable complexity. The degree of complexity depends on the underlying rules of the income tax. In a relatively clean system without a lot of special rules that require drawing dis-

[63]*See* McLure, *supra* note 26, at 67 (1990).

tinctions among many different categories of income and expense, the inflation-adjustment rules are not excessively complex. Perhaps the most complicated aspect is the inflation adjustment of indirect costs. For example, although inflation-adjusted depreciation by itself is not difficult to calculate, the absorption of depreciation and other expenses into the cost of items being produced by the firm in a context of rising prices is more complicated. If produced items are valued at the cost of production, but these costs are incurred over the course of several months, it is necessary to adjust the production costs incurred each month for inflation in order to express them all in comparable units. Such an exercise is complex, but the complexity is probably not substantially greater than that involved in absorption cost accounting generally.

Where inflation adjustment may become unworkable is in systems that are complex to begin with. If the rules of the income tax impose different substantive rules for different types of income (e.g., if different elements of foreign-source income are subject to separate foreign tax credit limitations), then each of the separate types of income must be calculated on an inflation-adjusted basis. Similarly, if special limitations apply to particular types of expenses, then these expenses must be calculated in inflation-adjusted terms. On the other hand, if the income tax law taxes all corporate income on an evenhanded basis, then the determination of total inflation-adjusted income under the net worth method is straightforward. To take the U.S. system as perhaps the extreme pole, where countless items of income and expense must be separately determined, one can imagine the effect of superimposing inflation-adjustment rules onto such a system. In contrast, the corporate income tax laws of many developing countries with high inflation rates are relatively simple, taxing all corporate income at a uniform rate and making few or no distinctions among different types of income. In the context of such relatively simple laws, inflation adjustment is feasible.

To the extent that there are concerns about complexity, the global adjustment method can be simplified by applying it only to the opening and closing balances. Instead of adjusting for inflation dividends, contributions to capital, exempt income, nondeductible expenses, and acquisitions of assets during the year according to the month of the transaction, a half-year convention for all these transactions could be used. The timing of transactions occurring during the year that involve either an increase or a decrease in net equity (contributions to capital, dividends paid) or the purchase of property subject to inflation adjustment (such as depreciable property or land) is ignored under this approach. Alternatively, the half-year convention could be applied to items involving numerous transactions during the year (e.g., nondeductible expenses), with less frequently occurring items (e.g., dividends) being accounted for on a monthly basis.

Such a simplified approach is similar to the approach Argentina took when it first introduced comprehensive adjustment. Unfortunately, under the very high inflation rates that prevailed in the early 1980s, taxpayers were able

to manipulate the inaccuracy of annual adjustment to their advantage. The so-called dynamic adjustment rules, which take into account transactions occurring during the year that involve an increase or a decrease in net equity or in the balance of assets subject to inflation adjustment, were consequently adopted in Argentina in 1985. This took care of the problem on a prospective basis, although in the meantime substantial loss carryovers had built up owing, in part, to the inaccuracy of the previous inflation-adjustment rules.

The lesson to be learned from the Argentine experience is that, while a global adjustment based on the opening balance sheet might be adequate at moderate inflation rates, once inflation gets close to or exceeds 100 percent a year, the inaccuracy of looking solely at the opening balance can have such a substantial effect on the computation of taxable income that a more sophisticated system is required.

Going in the opposite direction, a more accurate and slightly more complicated inflation-adjustment scheme is needed at much higher rates of inflation (several hundred percent a year or more). The global adjustment system can be adapted by keeping track not only of the month in which a transaction occurs, but also the date of the transaction. Brazil adopted such an approach when inflation exceeded 100 percent a year.[64]

Countries experiencing inflation rates that have been typical of most member countries of the Organization for Economic Cooperation and Development (OECD) (averaging below 10 percent a year, with occasional peaks of up to 20 percent or so) must consider whether it is necessary to make any adjustments for inflation. Even a low rate of inflation can have a substantial effect on the measurement of taxable income. For example, if the inflation rate is 3 percent and the real rate of interest is 4 percent, the inflationary component is nearly half the nominal interest rate of 7 percent. The absence of inflation adjustment can result in a substantial incentive to borrow in order to earn tax-deferred income. Despite the substantial effects of inflation on taxable income, the complexity of explicit inflation adjustment makes ad hoc adjustments attractive. (As discussed above, global adjustment in the context of a tax that is highly complex to begin with can involve substantial complexity.) If properly designed, ad hoc adjustments can work fairly well if the rate of inflation is both low and stable. If the inflation rate fluctuates, then ad hoc adjustments to the ad hoc adjustments may be required.

The global adjustment method is used in practice only by countries with relatively high inflation—30 percent or above—or by countries that have had such levels in the past and have consequently already put global adjustment into place. For other countries, the study of global adjustment is important in understanding what would be required to comprehensively adjust business income for inflation. To gauge the consequences of any proposed partial or ad hoc method, its effects can be compared with those produced under global ad-

[64]*See* Hiromi Higuchi & Fabio H. Higuchi, Imposto de Renda das Empresas 269–70 (1990).

justment. If the results differ substantially from those that would obtain under global adjustment, then this would be an important argument against adopting such a proposal in that form.

Appendix A. Global Adjustment Method in Detail

This appendix discusses the global adjustment method, using hypothetical statutory language in the form of excerpts from an income tax law that determines business income under the net worth method. Also included are commentary on this statutory language and examples of its application. The appendix should be read in conjunction with section III(D) above.

General Rules for Determining Taxable Business Income

The first element is the net worth calculation, which also serves as the basic rule for determining taxable income, set forth in article 1 as follows:[65]

Article 1. General rules for determining taxable business income

(1) Except as otherwise provided in this law, in the case of taxpayers who keep, or are required to keep, double-entry books, taxable business income is

- (a) the value of net worth in the closing tax balance sheet for the taxable period, less
- (b) the inflation-adjusted value of opening net worth, less
- (c) inflation-adjusted contributions to capital and inflation-adjusted incomes that are not taxable, plus
- (d) inflation-adjusted withdrawals made in favor of the owners and inflation-adjusted expenses that are not deductible.

(2) Net worth is the difference between

- (a) the total assets in the tax balance sheet, and
- (b) the sum of the debts of the taxpayer and reserves taken into account under the provisions of this law.

(3) The inflation-adjusted value of opening net worth is the value of net worth in the opening tax balance sheet, adjusted according to the percentage change in the CPI for the taxable year. The adjustment is made even if opening net worth is negative. The opening tax balance sheet is the same as the closing tax balance sheet for the preceding taxable period.

(4) Inflation-adjusted contributions to capital are contributions to capital made during the taxable period, adjusted according to the percentage change in the CPI between the month in which the contribution is made and the end of the taxable period. Inflation-adjusted incomes that are not taxable are incomes that are not taxable under the provisions of this law, adjusted ac-

[65]This article is based on FRA CGI art. 38 and CHL IR art. 41.

cording to the percentage change in the CPI between the month in which the income is received and the end of the taxable year.

(5) Inflation-adjusted withdrawals made in favor of the owners are distributions or other transfers of property in favor of the owners made during the taxable period, adjusted according to the percentage change in the CPI between the month in which the distribution or transfer is made and the end of the taxable period. Inflation-adjusted expenses that are not deductible are expenses paid during the taxable period, other than capital expenditures, that are not allowed as deductions under this law, adjusted according to the percentage change in the CPI between the month in which the expense is paid and the end of the taxable period.

Comments on Article 1

(1) The term "tax balance sheet" (sometimes "balance sheet" for short) refers to the balance sheet used for tax purposes. Because the accounting rules prescribed by the tax law differ in certain respects from the commercial accounting rules, the tax balance sheet will generally differ from the commercial balance sheet. In the case of individuals, assets and debts that are not related to the generation of business income are excluded from the balance sheet for inflation-adjustment purposes.[66]

(2) Because the global adjustment is based on the balance sheet, only taxpayers who keep such a balance sheet can apply it.[67] Therefore, the scope of application of the global adjustment will depend on the rules explaining what taxpayers are required to keep a balance sheet. In many countries, this is defined with reference to the requirements of the commercial code. Any taxpayer with a substantial business should be required to use double-entry bookkeeping and keep a balance sheet.

(3) Under paragraph (3), it is necessary to determine the amount of the taxpayer's liabilities. This requires a distinction between "debt" and "equity." Although rules on this issue must be provided, the problem is not as intractable as it may seem. The reclassification of an item as equity rather than as debt will not completely throw off the net worth calculation because the same item will normally appear in both the opening and the closing balances.

(4) In Chile, the law defines the opening net equity subject to adjustment as "the difference between the assets and debts on the date of the beginning of the commercial year, having removed intangible, nominal, transitory, and pro forma values and others as determined by the National Tax Director-

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[66]*See* CHL IR art. 41(1).

[67]*See* CHL IR art. 41; Circular No. 100, of Aug. 19, 1975 [hereinafter Circular]; *reprinted in* Hugo Contreras & Leonel Gonzalez, Manual de Corrección Monetaria 402 (1989). Inflation adjustment therefore does not apply to taxpayers who determine their income on a presumptive basis. *See id.* at 54; CHL IR art. 34.

ate, that do not represent effective investments."[68] Circular No. 100 explains the references to nominal, transitory, and pro forma assets as those that result from estimated values.[69] It gives the following examples of assets that could be nominal assets (which it also calls intangible values): franchises, trademarks, patents for inventions, and concessions. Examples of transitory assets are provisional dividends and personal withdrawals. Pro forma accounts are accounts whose purpose it is to reflect responsibilities or other information for the financial accounting of the enterprise (e.g., shares under guaranty, endorsed bills, discounted bills, contracts in progress). In other words, the types of assets to be excluded in computing opening net equity are those that are either not really part of the taxpayer's assets, although they may be reflected on the balance sheet for accounting purposes, or, as in the case of intangible assets, are assets that in any event should have a zero tax book value. Presumably, it is not intended to exclude from the calculation intangibles that were purchased by the taxpayer and that accordingly have a positive tax book value.

(5) It is sometimes not clear whether an asset should be treated as owned by the taxpayer and hence whether it should properly be included in the balance sheet. Rules are needed, for example, on the circumstances under which property leased to the taxpayer is treated as owned by the taxpayer and therefore includable in the balance sheet (and conversely, the circumstances under which property nominally owned by the taxpayer and leased to someone else under a finance lease may be properly treated as not part of the balance sheet).[70] As with the debt-equity problem, the gravity of the problem is diminished by the offsetting effects of the opening and closing balances.

(6) The second sentence of paragraph (3) makes it clear that the adjustment should also be made when there is negative opening net equity. This is the opposite of the rule applicable in Chile.[71] As a matter of logic, there is no reason to treat a negative amount differently from a positive amount as far as inflation adjustment is concerned.

(7) Paragraphs (4) and (5) refer to items being "received," distributions being "made," and items being "paid." The implication is that the time that a transaction is taken into account for purposes of inflation adjustment is according to the cash method, even if the taxpayer uses the accrual method of accounting. This issue has not always been dealt with clearly in countries with global adjustment. For example, with respect to dividends, in Chile it is considered that a dividend that is declared and available to the shareholder but not yet paid is a diminution of net equity on the date so available.[72] In such a

[68]CHL IR art. 41(1).

[69]*See* Contreras & Gonzalez, *supra* note 67, at 413.

[70]*See supra* note 46.

[71]*See* Contreras & Gonzalez, *supra* note 67, at 88–89; Circular No. 27 (Mar. 8, 1976) (Chile), *reprinted in id.* at 457–58.

[72]*See* Contreras & Gonzalez, *supra* note 67, at 207.

case, however, the funds to be devoted to the payment of the dividend are still earning taxable income for the corporation; accordingly, paragraph (5) considers the distribution as not taking place until it is actually paid.

(8) Compare the wording of paragraphs (4) and (5) with the Chilean law,[73] which provides that "increases in net equity taking place during the year" are adjusted according to the difference in the price index between the last day of the month preceding the increase and the last day of the month preceding the month of the balance sheet. The same treatment applies to decreases in net equity. "Personal withdrawals of the entrepreneur or partner, dividends distributed by corporations, and any amount invested in goods or rights that the law excludes from the net equity are considered in any event decreases in capital and are adjusted in the manner described above." The above language has led to a problem of interpretation in Chile because it does not make clear whether the profits of each month of the current year should be treated as "increases in net equity."[74] Literally, these profits are increases in net equity, but the logic of inflation adjustment would not call for their adjustment.

Article 2. Valuation of assets and debts in closing balance

(1) In applying article 1, assets (other than inventory) and debts included in the closing tax balance sheet are valued as prescribed in this article.

(2) The values of assets (other than assets described in paragraphs (3)–(8)) are adjusted according to the percentage change in the CPI. The value of an asset on hand at the beginning of the year is adjusted according to the percentage change in the CPI for the taxable year. The value of an asset acquired during the taxable year is adjusted according to the percentage change in the CPI between the month in which it was acquired and the end of the taxable year.

(3) Assets for which depreciation is allowed under article [ ] (relating to depreciation deduction)[75] are valued according to the balance of the depreci-

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[73]CHL IR art. 41(1).

[74]*See* Contreras & Gonzalez, *supra* note 67, at 198, reporting a Supreme Court decision holding that monthly profits of the current year should not be treated as an increase in net equity for purposes of the inflation-adjustment rules; Oficio No. 3,231 (June 9, 1976) (CHL), *reprinted in id.* at 460.

[75]Assuming that pooled depreciation with a declining balance method is used, the balance of each pool at the end of the year would be valued as follows under the depreciation article:

The balance of a pool at the end of the taxable year is the amount determined as follows (but not less than zero):

(a) the inflation-adjusted balance of the pool at the end of the preceding taxable year; less
(b) the inflation-adjusted amount allowed for the preceding taxable year as depreciation; plus
(c) the inflation-adjusted cost of assets added to the pool in the taxable year; less
(d) the inflation-adjusted amounts received from the disposal of assets in the pool during the taxable year.

The items in the preceding paragraph are adjusted for inflation as follows. Items (a) and (b) are adjusted for inflation for the current taxable year. Item (c) is adjusted for inflation between the month in which the asset is added to the pool and the end of the taxable year. Item (d) is adjusted for inflation between the month in which the asset is disposed of and the end of the taxable year.

ation pools at the end of the taxable year, reduced by the depreciation for the taxable year.

(4) Debt claims and debts (other than those described in paragraph (6)) are valued by including accrued interest (including original issue discount or market discount) and accrued adjustments to principal (including adjustments under an adjustment clause).

(5) (a) Foreign currency; and

(b) debt claims, other assets, or debts denominated in foreign currency

are valued at the prevailing foreign exchange rate at the end of the taxable year.

(6) Publicly traded securities are valued at their market quotation as of the end of the taxable year.

(7) Gold or silver bullion or coins are valued according to the market price as of the end of the taxable year.

(8) Cash and assets denominated in national currency are valued at their nominal value.

Article 3. Valuation of inventories and unfinished products

(1) In applying article 1, assets and unfinished products included in the closing inventory are valued as provided in this article.

(2) Goods of a particular type are valued at the cost of the last-acquired item of that type, adjusted according to the percentage change in the CPI between the month in which the item was acquired and the end of the taxable year. The preceding sentence applies only if the last-acquired item was acquired during the taxable year.

(3) If no item of such type has been acquired in the taxable year, the goods are valued at the value in the opening balance, adjusted according to the percentage change in the CPI for the taxable year.

(4) Goods included in closing inventory that are produced, rather than purchased, including unfinished products, are valued according to the same principles, in relation to the costs incurred in their production.

(5) For purposes of this article, an acquisition at an artificial price will be ignored.

Comments on Articles 2 and 3

(1) As discussed above, the general approach under articles 2 and 3 is to value items at prices prevailing at the end of the year. In performing this exercise, assets that are denominated in units of national currency, that is, cash, bank deposits, debt instruments, and the like (e.g., preferred stock) are not adjusted for inflation. The reason for this is that the value of such items does not increase with inflation. However, when a debt instrument contains an adjustment clause, whereby the nominal amount of the obligation is increased (typ-

ically, in countries with high inflation, the adjustment clause will be some formula related to inflation), then under article 2(4), the debt instrument is valued at its nominal amount.

(2) The general rule of article 2(2) is to adjust the tax cost for inflation occurring either during the year or since the time of acquisition. This is also the general approach for depreciable property. Valuation rules for other specific types of property are provided in paragraphs (4) through (8), and in article 3.

(3) In general, paragraphs (4) through (7) of article 2 provide for valuation at market value or an approximation of market value. In particular, paragraph (4) contemplates full accrual for financial instruments.[76] As Vann and Dixon point out, such accrual taxation is essential in an environment of global adjustment.[77] Of course, implementation of this principle is a challenge, requiring the development of detailed regulations.

(4) The valuation at year-end prices of foreign currency, foreign-currency-denominated debt instruments, publicly traded securities, and gold and silver is easier because market quotations exist. There are some definitional issues: foreign-currency-denominated debt instruments need to be distinguished from equity, and "publicly traded" and "securities" must be defined.

(5) Under article 3, the closing inventory balance is valued according to a set of rules that have the general effect of valuing the inventory at the acquisition or production cost as of the end of the year.[78] These rules require the division of inventory into different products, because it is necessary to decide when the last item of a particular product was purchased. The most difficult problem is the specification of production costs and their allocation to different months. Taxpayers should be allowed a fair amount of flexibility to fashion cost accounting rules that are suitable to their production methods and accounting capabilities.

Examples

EXAMPLE 1

At the beginning of the taxable year, a firm owns only one asset, land, with a book value of $100. It has indebtedness of $80, so that its opening net equity is $20. The stylized facts in this example are the following:

(a) The annual inflation rate is 50 percent;
(b) The nominal interest rate is 55 percent;
(c) At the end of the year, the firm earns $44 from the sale of services. The firm uses this money to pay interest on the loan in the amount of $44.

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[76]The same is contemplated under the rules of Chile. *See* Contreras & Gonzalez, *supra* note 67, at 301.

[77]*See* Vann & Dixon, *supra* note 27, at 78.

[78]*See* CHL IR art. 41(3).

The firm's balance sheet at the beginning of the year and the inflation-adjusted balance sheet at the end of the year appear as follows:

OPENING BALANCE SHEET

Assets		**Liabilities**	
Land	$100	Debt	$80
		Net equity	$20

CLOSING BALANCE SHEET

Assets		**Liabilities**	
Land	$150	Debt	$80
		Net equity	$70

Notice that without inflation adjustment, taxable income is zero. The gross income of $44 is offset by the interest deduction. The problem with this result is that $40 of the interest deduction is the inflation component of the debt. If a deduction for this amount is denied, the taxable income becomes $40.

To reach this result under the global adjustment method, we need to ascertain the taxpayer's opening net worth. This is the difference between the total value of the taxpayer's assets and its debts, as shown on the opening balance sheet.[79] This amount is multiplied by the change in the price index between the beginning and the end of the year.[80] In example 1, inflation-adjusted opening net worth is 150 percent of $20, or $30.

Therefore, under the net worth calculation set forth in article 1 above, taxable income is as follows:

Closing net worth	$70
Less inflation-adjusted opening net worth	$30
Equals taxable income	$40

EXAMPLE 2

This example illustrates a more complex case involving the calculation of depreciation and valuation of inventory under inflation. The following assumptions apply:

(a) the inflation rate is 100 percent;
(b) the real interest rate is 5 percent;

[79]*See* CHL IR art. 41(1).

[80]For simplicity, the example refers to adjustment for inflation occurring between the beginning and the end of the year (or between a given month and the end of the year). The actual adjustment mechanism in Chile does not use the price indices for the month of January (or any other month for transactions that occur during the year) and December, but rather uses the index for the last day of November of the current year and of the preceding November (or, in general, of the month preceding the transaction). *See* CHL IR art. 41(1). This is presumably done as a matter of convenience, so that tax liability can be calculated immediately after the end of the year without awaiting publication of the price index for December 31.

(c) given (a) and (b), the nominal interest rate, with interest payable at the end of the year, is 110 percent;
(d) the firm owns one machine, the depreciation rate on which is 20 percent; and
(e) at the beginning of the year, the firm has 100 units of inventory that cost $10 a unit.

Given these facts, the firm's opening balance sheet is as follows:

OPENING BALANCE

Assets		**Liabilities**	
Machine	$1,000	Debt	$1,000
Inventory	$1,000	Net equity	$1,000
Total assets	$2,000		

The only activity occurring during the year is that, on December 31, the company sells 90 units for $2,100 and manufactures 125 units at a cost of $2,100 in cash and $400 allocated depreciation,[81] for a total cost of $2,500. The taxpayer borrows an additional $1,100 on December 31 to cover the interest payment made on that date. The closing balance will therefore be as follows:

CLOSING BALANCE

Assets		**Liabilities**	
Machine	$1,600	Debt	$2,100
Inventory[82]	$2,700	Net equity	$2,200
Total assets	$4,300		

Taxable income therefore is $2,200 (closing net worth) less $2,000 (inflation-adjusted opening net worth), which equals $200.

In this case, without an inflation adjustment based on balance sheets, one could eliminate the effect of inflation by providing partial adjustments:

(a) calculate depreciation allowances using an indexed cost;
(b) calculate the cost of goods sold by using indexed FIFO (the same result would obtain in this case under LIFO); and
(c) deny a deduction for the inflation component of the debt.

[81]Notice that the depreciation is computed on the basis of the inflation-adjusted tax cost of $2,000.

[82]The 135 units of closing inventory are valued at $20 each, which is the most recently incurred unit cost of production. In this example, the same result would be reached by indexed FIFO (i.e., adjusting the initial $10 cost for inflation to $20).

With this set of partial adjustments, depreciation increases from $200 to $400 (because this is a cost of production, the depreciation is not currently deductible, but is included in the cost of inventory), the cost of the 90 units sold would double from $900 to $1,800, and the deduction for interest expense is reduced from $1,100 to $100. Accordingly, taxable income is determined as follows:

Sales	$2,100
Less cost of goods sold	$1,800
Less real interest expense	$100
Equals taxable income	$200

The result under comprehensively applied partial adjustment is the same as under global adjustment owing to the assumption that all activity takes place at the end of the year.[83]

EXAMPLE 3

This example, which is a little more complicated than example 2, illustrates the effect of the timing of transactions taking place during the year.

The opening balance consists solely of $1,000 of inventory, consisting of 100 units purchased for $10 each.

On July 1 (price level 200), the company sells its inventory for $2,500. Consider two variants. Under variant *A*, the company distributes a dividend of $2,500 on the same day. Under variant *B*, it invests $2,500 in the bank, receiving interest of $2,500 for the remainder of the year.

The closing balance on December 31, at a time when the price level has risen to 400, is therefore

Variant *A*:	0 cash and 0 net worth
Variant *B*:	$5,000 cash and $5,000 net worth

Taxable income is computed as follows:

	Variant A	**Variant B**
Closing net worth	$0	$5,000
Less inflation-adjusted opening net worth	$4,000	$4,000
Plus inflation-adjusted distributions	$5,000	—
Equals taxable income	$1,000	$1,000

Notice what difficulty a partial approach would have in dealing with this case. A profit of $500 on the sale of the inventory could be computed, but the calculation would require adjusting the opening inventory for inflation only up to the time of the sale rather than to the end of the year. This would not be difficult to do in this example, but what about more complicated cases involving numerous sales during the year? The $2,500 of interest income in variant *B* could be eliminated under a partial approach. This would leave taxable in-

[83]See *supra* sec. IV, fourth paragraph.

come of $500 under both variants, which would be fine if the tax year were closed and tax paid on July 1, but disastrous for the tax collector if tax were not paid until after the end of the year.

Appendix B. Global Adjustment in the Context of Income-Less-Expenses Method of Determining Taxable Income

Summary

In the case of an income tax where taxable income is calculated as the difference between gross income and expenses, the inflation adjustments to be made are the same as explained in Appendix A, but instead of being embodied in the net worth calculation they take the form of additions to and subtractions from taxable income. The result reached is the same as under the net worth method. (The adjustments are described here in summary form; for a detailed explanation of the terms used, see Appendix A.)

The inflation-adjustment rules apply to enterprises preparing financial statements and are based on the value of assets and liabilities included in the balance sheet of the enterprise. The values of items included in the closing balance sheet are adjusted for inflation taking place during the year. The total amount of these inflation adjustments is added to taxable income.

The amount of net worth (assets minus debts) in the opening balance sheet is adjusted for inflation, and this adjustment is subtracted from taxable income. The adjustment is corrected for certain transactions taking place during the course of the year that result in a change in net worth. The inflation adjustment to transactions resulting in an increase in net worth is subtracted from taxable income. The inflation adjustment to transactions resulting in a decrease in net worth is added to taxable income.

The net effect of inflation adjustment on taxable income is the algebraic sum of these adjustments, which are described below.

Adjustment of Opening Net Worth

The amount of opening net worth is adjusted for inflation for the taxable year. The amount of this adjustment is subtracted from taxable income. In the event that the opening net worth is negative, the above operation results in an increase in taxable income because a negative number is being subtracted.

Adjustment of Increases in Net Worth

Contributions to capital and nontaxable income are adjusted for inflation occurring between the month in which the transaction takes place and the

close of the taxable period. The total amount of these adjustments is subtracted from taxable income.

Adjustment of Decreases in Net Worth

Distributions to owners and nondeductible expenses are adjusted for inflation occurring between the month in which the transaction takes place and the close of the taxable period. The total amount of these adjustments is added to taxable income.

Adjustment of Items in Closing Balance

The value of items in the closing balance is adjusted as described in Appendix A, depending on the type of asset or debt. The amount of the adjustment, that is, the difference between (1) the adjusted value of the asset or debt; and (2) its historical cost, if acquired during the year, or its value on the previous balance sheet, is added to taxable income (subtracted in case of adjustment of a debt).

Table of Tax Laws Cited

Country and Regional Abbreviations

	Abbreviation		Abbreviation
Albania	ALB	Latvia	LVA
Argentina	ARG	Lesotho	LSO
Australia	AUS	Macedonia, former Yugoslav Rep. of	MKD
Austria	AUT	Mali	MLI
Belgium	BEL	Mauritania	MRT
Bolivia	BOL	Mexico	MEX
Brazil	BRA	Netherlands	NLD
Bulgaria	BGR	New Zealand	NZL
Canada	CAN	Norway	NOR
Chile	CHL	Pakistan	PAK
China	CHN	Papua New Guinea	PNG
Colombia	COL	Peru	PER
Côte d'Ivoire	CIV	Philippines	PHL
Czech Republic	CZE	Portugal	PRT
Denmark	DNK	Romania	ROM
Dominican Republic	DOM	Russia	RUS
Ecuador	ECU	Sierra Leone	SLE
Estonia	EST	Singapore	SGP
Finland	FIN	Slovak Republic	SVK
France	FRA	Slovenia	SVN
Germany	DEU	South Africa	ZAF
Guinea	GIN	Spain	ESP
Hong Kong	HKG	Sweden	SWE
India	IND	Switzerland	CHE
Ireland	IRL	Togo	TGO
Israel	ISR	United Kingdom	GBR
Italy	ITA	United States	USA
Japan	JPN	Venezuela	VEN
Kazakstan	KAZ		
Korea	KOR		

Tax Laws

Albania ALB	SBT	Ligj nr. 7679 Për tatimin mbi biznesin e vogël (Law on Small Business Tax), of Mar. 3, 1993; *reprinted in* The Albania Law Report (Albal SH. P.K. Tirana), Compilation of Legal Acts of Albania as amended, at 49, Oct. 1995 [in Albanian] [English trans.].
Argentina ARG	APFI	Procedimiento para la Aplicación, Percepción y Fiscalización de Impuestos (Procedures for the Application, Collection and Inspection of Taxes), Ley Nº 11.683, B.O. Dec. 11, 1978 (as amended to 1991 by Law Nº 23.905, B.O. Feb. 18, 1991); *reprinted in* 1 Legislación Impositiva 1991, at 1, La Ley [in Spanish].
	IVA	Impuesto al Valor Agregado (Value Added Tax), Ley Nº 23.349, B.O. Aug. 25, 1986 (as amended by Ley Nº 23.905, B.O. Feb. 18, 1991) *Id.* at 383.
	IA	Impuesto sobre los Activos (Tax on Assets), Ley Nº 23.905, B.O. Dec. 18, 1990 (as amended by Ley Nº 23.905, B.O. Feb. 18, 1991) *Id.* at 279; also [English translation] *reprinted in* TLW at 44 (as amended to Sept. 1993).
Australia AUS	ITAA	Income Tax Assessment Act 1936; *reprinted in* 1A and 1B Australian Income Tax Legislation (as amended to June 30, 1992) (CCH Australia Limited 1992).
	CTO	Crimes (Taxation Offences) Act 1980; *Id.* at 72,003.
Austria AUT	UStG	Umsatzsteuergesetz 1972 (Turnover Tax Law), BGBl 1972/223; *reprinted in* Kodex des Österreichischen Rechts: Steurrecht (Christoph Ritz ed., 16th ed., LINDE VERLAG WIEN 1993) (as amended to 1993) [in German] [as of Jan. 1, 1995, UStG 1994, BGB1 663].
	BAO	Bundesabgabenordnung (Federal Fiscal Code), BGBl 1961/194; *Id.*
Belgium BEL	CIR	Code des Impôts sur les Revenus (Income Tax Code); *reprinted in* Code des Impôts sur les Revenus 1992 (Ministère des Finances, Administration des Contributions Directes 1992) (as amended to July 1992) [in French] and 4 TLW [English trans.].
Bolivia BOL	IRPE	Impuesto a la Renta Presunta de Empresas (Tax on Presumptive Income of Businesses), Ley Nº 843 of May 20, 1986; *reprinted in* 1 Recopilación Tributaria al 31 de diciembre de 1992, at 163 (Dirección General de Impuestos Internos 1993) (as amended to Dec. 31, 1992) [in Spanish].
Brazil BRA	CTN	Lei Nº 5.172 Código Tributário Nacional (National Tax Code) of Oct. 25, 1966; *reprinted in* Editora Saraiva, Código Tributário Nacional, at 21 (1990) [in Portuguese].

Note: Tax Laws of the World (Foreign Tax Law Publishers) is abbreviated as TLW. Tax Notes International is abbreviated as TNI. Laws cited are not necessarily those currently in force at time of publication.

Bulgaria BGR	VAT	Zakon za Danak varkhu Dobavenata Stoynost (Law on Value Added Tax), Official Gazette, Nº 90 of 1993; *reprinted in* Danachno Oblagane za 1994 Godina 202 (IK "Trud i Pravo" 1995) [in Bulgarian], and [English trans.] from 168 Hours British Broadcasting News (BBN), vol. 3, Nos 46 and 47, Nov. 15–21 and 22–28, 1993.
Canada CAN	ITA	Income Tax Act, R.S.C. 1985; *reprinted in* H. Stikeman, Stikeman Income Tax Act, Annotated (23rd ed., Carswell Thomson Professional Publishing 1994) (as amended to July 31, 1994).
	GST	Goods and Services Tax provisions contained in the Excise Tax Act, R.S.C. 1985; *reprinted in* The Practitioner's Goods and Services Tax, Annotated (David M. Sherman, ed., 4th ed., Carswell Thomson Professional Publishing 1994) (as amended to Aug. 15, 1994).
Chile CHL	CT	Decreto Ley Nº 830 sobre Código Tributario (Tax Code) D.O. del 31 de diciembre de 1974 y actualizado hasta el 31 de julio de 1994; *reprinted in* Textos Legales, Servicio de Impuestos Internos, at 331, Arrayan ed. (1995) [in Spanish].
	IR	Decreto Ley Nº 824 de Impuesto a la Renta (Income Tax), D.O. del 31 de diciembre de 1974 y actualizado hasta el 4 de febrero de 1995; *Id.* at 9.
	IHAD	Decreto Ley Nº 16.271, de Impuesto a las Herencias, Asignaciones y Donaciones (Inheritance and Gift Tax Law) D.O. del 10 de julio de 1965 y actualizado hasta el 31 de diciembre de 1994; *Id.* at 571.
China CHN	VAT	Provisional Regulations of the People's Republic of China on Value-Added Tax, enacted by the State Council on Dec. 13, 1993; *reprinted in* National Taxation Bureau, Foreign Taxation Administration Department, A Collection of Tax Laws and Regulations of the People's Republic of China, at 102 (State Statistical Bureau 1994) [in Chinese, with English trans.].
	LT	Provisional Regulations of the People's Republic of China on Land Appreciation Tax, enacted by the State Council on Dec. 13, 1993; *Id.* at 224.
	TA	The Law of the People's Republic of China Concerning the Administration of Tax Collection, enacted by the Standing Committee, National People's Congress on Sept. 4, 1992; *Id.* at 236.
Colombia COL	ET	Estatuto Tributario (Taxation Statute), Decreto Nº 624 (del 30 de marzo de 1989); *reprinted in* Rodrigo Monsalve T., Impuestos 1991 (renta, ventas e indirectos), at 51 (Centro Interamericano Jurídico-Financiero 1991) (as amended to 1991) [in Spanish].

Côte d'Ivoire CIV	CGI	Code Général des Impôts 1981 (General Tax Code); *reprinted in* Republique de Côte d'Ivoire, Code Général des Impôts (Impr. Nationale 1981) (as amended to Dec. 31, 1980) [in French].
Czech Republic CZE	IHT	Zákon Nº 357 České národní rady o dani dědické, dani darovací a dani z převodu nemovitostí (Law on Inheritance Tax, Gift Tax, and Real Estate Transfer Tax); *reprinted in* Sbírka zákonů, at 1993 (July 7, 1992) [in Czech].
		Zákon Nº 322 kterým se mění a doplňuje zákon České národní rady č Nº 357/1992 Sb., o dani dědické, dani darovací a dani z převodu nemovitostí, ve znění zákona České národní rady č Nº 18/1993 Sb. (Amendments to Law Nº 357 on Inheritance Tax, Gift Tax, and Real Estate Transfer Tax); *reprinted in* Sbírka zákonů, at 1753 (Dec. 30, 1993).
		Zákon kterým se doplňuje zákon České národní rady č Nº 357/1992 Sb., o dani dědické, dani darovací a dani z převodu nemovitostí, ve znění zákona České národní rady č Nº 18/1993 Sb. zákona č 322/1993 Sb. zákona č 42/1994 Sb. zákona č 85/1994 Sb. (Amendments to Law Nº 357 on Inheritance Tax, Gift Tax, and Real Estate Transfer Tax); *reprinted in* Sbírka zákonů, at 1162 (July 8, 1994).
Denmark DEN	INH	Arve- og gaveafgiftsloven (Act on Inheritance and Gift Tax) Lovbekendtgørelse nr. 62 af 6. februar 1987 om afgift af arv og gave; *reprinted in* Danske Skattelove 1990/1991 med henvisninger (Peter Tarnoj ed., A/S/ Skattekartoteket Informationskontor 1990) (as amended through July 1990) [in Danish]. Also *reprinted in* 9 TLW, at 89 (as amended to Nov. 1988) [English trans.].
Dominican Republic DOM	CT	Código Tributario de la República Dominicana (Tax Code of the Dominican Republic); *reprinted in* Código Tributario de la República Dominicana (1992), Government Publisher [in Spanish] *translated in* 9 TLW (as amended to Nov. 1993) [English trans.].
Ecuador ECU	CT	Código Tributario, Ley Nº 55 of June 13, 1994; *reprinted in* Corporación de Estudios y Publicaciones, Código Tributario [in Spanish].
Estonia EST	LOT	Law on Taxation, RT I 1994, 1, 5; *reprinted in* Estonian Taxes 5 (Piret Joalaid ed., Marje Einre trans., AS Vaba Maa 1994) (as amended to Mar. 16, 1994) [English trans.].
	IT	Income Tax Law, RT I 1993, 79, 1184; *Id.* at 26.
	VAT	Law on Value Added Tax, RT I 1993, 60, 847; *Id.* at 49.
	LND	Law on Land Tax, RT 1993, 24, 428; *Id.* at 69.
	GAM	Law on Gambling Tax, RT 1992, 35, 458; *Id.* at 73.
France FRA	CGI	Code Général des Impôts 1993 (General Tax Code); *reprinted in* Code Général des Impôts (22nd ed., Dalloz 1993) (as amended to May 15, 1992) [in French].

	LPF	Livre de Procédures Fiscales 1992, Ministère du Budget, Impr. Nationale 1992 [in French].
Germany DEU	AO	Abgabenordnung 1977 (Fiscal Code), BGBl I S. 613, ber. BGBl 1977 I S. 269; *reprinted in* Deutsche Steuergesetze 1992, at 12 (4th ed., IDW-Verlag GmbH 1992) (as amended to 1992) [in German].
	FVG	Gesetz über die Finanzverwaltung (FVG) (Law on Tax Administration) of Aug. 30, 1971, BGBl I S. 1426; *Id.* at 235.
	EStG	Einkommensteuergesetz 1990 (Income Tax Law), BGBl I S. 1898; *Id.* at 260.
	KStG	Körperschaftsteuergesetz 1991 (Corporation Tax Law) of Mar. 11, 1991, BGBl I, 639; *Id.* at 714.
	UStG	Umsatzsteuergesetz 1991 (Turnover Tax Law) of Feb. 8 1991, BGBl I S. 351; *Id.* at 784.
	VStG	Vermögensteuergesetz (Wealth Tax Law) of Nov. 14, 1990, BGB1 I S. 2467; *Id.* at 958.
	ErbStG	Erbschaftsteuergesetz (Inheritance Tax Law) of Feb. 19, 1991, BGBl I S. 469; *Id.* at 976.
	StBerG	Steuerberatungsgesetz (Tax Advising Law) of Nov. 4, 1975, BGBl I S. 2735; *Id.* at 1126.
Guinea GIN	CIDE	Code des Impôts Directs d'Etat, 1990.
Hong Kong HKG	EDO	Estate Duty Ordinance, *reprinted in* Handbook of Hong Kong Tax Statutes (Chapter 111, 1983 rev. ed.), as amended, Butterworths (1990).
India IND	IT	Income Tax Act, 1961; *reprinted in* 16 TLW (as amended through Finance Act, 1992).
Ireland IRL	VAT	Value Added Tax Act, 1972; *reprinted in* Ireland, Office of the Revenue Commissioners, Law of Value-Added Tax After Enactment of Finance Act, 1985 on 30 May, 1985 (Stationery Office 1985) (as amended to May 30, 1985).
Israel ISR	IT	Income Tax Ordinance; *reprinted in* Income Tax Ordinance, Amendments N$^{\underline{os}}$ 91 to 94 (A.G. Publications 1993) (as amended to Oct. 1, 1993) [English trans.].
	VAT	Value Added Tax; *reprinted in* 19 TLW (as amended to Apr. 1989) [English trans.].
Japan JPN	CTL	Consumption Tax Law; *reprinted in* Japan—National Consumption Tax Law: An English Translation with Cabinet Orders as at Apr. 1, 1989 with an introduction by Prof. Koji Ishimura (CCH International 1989) [English trans.].
	IHT	Law Nº 73 The Inheritance Tax Law of Mar. 31, 1950; *reprinted in* The Inheritance Tax Law of Japan, IV EHS Law Bulletin Series, Eibun-Horei-Sha, ed. (as amended to Mar. 1975) (1975) [English trans.].

Kazakstan KAZ	TC	Ukaz O Nalogakh i Drugikh Obyazatel'nykh Platezhakh v Byudzhet (Decree Concerning Taxes and Other Compulsory Payments to the Budget of Apr. 16, 1995) (Tax Code); *reprinted in* O Nalogakh i Drugikh Obyazatel'nykh Platezhakh v Byudzhet: Ukaz Prezidenta Respubliki Kazakstan, imeyushchiy silu zakona (Karzhy-karazhat 1995) [in Russian]. Also 95 TNI 84-16 (doc. 95-20820 and doc. 95-20614) [English trans.].
Korea KOR	BNTA	Basic National Tax Act, Law Nº 2679 Dec. 21, 1974 (as amended to Dec. 31, 1993); *reprinted in* Korean Legal Center, 2 Laws of the Republic of Korea, 4th ed. [English trans.].
Latvia LVA	TF	Law on Taxes and Fees, Feb. 2, 1995, 95 TNI 70-20, doc. 95-2044 [English trans.].
	ET	Law on Excise Tax of Dec. 1990, as amended to Mar. 1995 [unpublished English trans.].
	EIT	Law on Enterprise Income Tax, Feb. 9, 1995, 95 TNI 64-26, doc. 95-20442 [English trans.].
Lesotho LSO	IT	Income Tax Order 1993, 38 Lesotho Government Gazette Extraordinary Nº 33, at 403, amended by Income Tax (Amendment) Act 1994, 39 Lesotho Government Gazette Extraordinary Nº 54, at 552.
Macedonia, former Yugoslav Rep. of MKD	PPT	Law on Property Tax, Ministry of Finance, as updated to Dec. 30, 1993 [English trans.].
Mali MLI	CGI	Code Général des Impôts (General Tax Code); *reprinted in* Code Général des Impôts (Editions du Cabinet de Conseil Fiscal 1991) (as amended to Dec. 31, 1991) [in French].
Mauritania MRT	CGI	Code Général des Impôts (General Tax Code); *reprinted in* Mauritania, Ministère des Finances, Code Général des Impôts, mise à jour: Loi de Finances 1990 (Ministère des Finances 1990) [in French].
Mexico MEX	CF	Código Fiscal de la Federación 1988 (Federal Tax Code); Secretaría de Hacienda y Crédito Público [in Spanish] (1988).
	ATL	Ley del Impuesto al Activo (Assets Tax Law), Diario Oficial, Dec. 31, 1988, Cap 5, Art. 10 de la ley que establece, reforma, adiciona y deroga diversas disposiciones fiscales, vigente a partir del 1º de enero 1989 [in Spanish].
Netherlands NLD	Vpb	Vennootschapsbelasting 1969 (Corporation Income Tax Law); *reprinted in* Belastingwetgeving 1995, at 158 (Koninklijke Vermande) (as amended to 1994 [in Dutch].
	AWR	Algemene wet Inzake Rijksbelastingen 1959 (General Tax Code), Stb. 301; *Id.* at 498.

New Zealand NZL	GST	Goods and Services Tax Act; *reprinted in* Goods and Services Tax Legislation (5th ed., Commerce Clearing House New Zealand Limited 1990) (as amended to Sept. 1, 1990).
	EGD	Act Nº 35 Estate and Gift Duties, Nov. 25, 1968; *reprinted in* Statutes of New Zealand, New Zealand Government, 1979.
Norway NOR	Aal	Arveavgiftloven (Lov om avgift på arv og visse gaver av. 19 juni. 1964 nr. 14) (Inheritance Duty Act).
Papua New Guinea PNG	WPA	Wills, Probate, and Administration Act Nº 68 of 1967, as amended to Jan. 1980; *reprinted in* 10 The Revision of Laws, Independent State of Papua New Guinea, 1980.
Peru PER	CT	Decreto Supremo Nº 395-82-EFC Código Tributario (Supreme Decree: Tax Code), El Peruano, 6 de enero de 1983; *reprinted in* Código Tributario, Ministerio de Economía y Finanzas, Dirección General de Contribuciones (1985).
Philippines PHL	NIRC	National Internal Revenue Code of 1977; *reprinted in* The National Internal Revenue Code of the Philippines, as amended by R.A. Nºs 7496, 7497, and 7499 (Jose N. Nolledo ed., National Bookstore, Inc. 1992) (as amended to 1992).
Portugal PRT	CIVA	Código do Imposto sobre o Valor Acrescentado (Value Added Tax Code), Decreto-Lei Nº 394-B/84 de 26 de dezembro; *reprinted in* Código do Imposto sobre o Valor Acrescentado (Rei dos Livros 1984) [in Portuguese].
	ISD	Código da Sisa e do Imposto sobre as Sucessões e Doações (Transfer, Succession and Gift Tax Code) Decreto-Lei Nº 41 969, de 24 de novembro de 1958; *reprinted in* Código da Sisa e do Imposto sobre as Sucessões e Doações, Rei dos Livros 5ª ed. (as amended to 1987) [in Portuguese].
Romania ROM	PT	Ordonanţa privind Impozitul pe Profit (Profit Tax Law), Monitorul Oficial al Romaniei, Aug. 31, 1994 [in Romanian].
Russia RUS	TS	Law Nº 2118-1 of the Russian Federation of Dec. 27, 1991 Concerning the Fundamental Principles of the Taxation System in the Russian Federation [English trans. by Ernst & Young] (as amended through Federal Law Nº 9-FZ of the Russian Federation of July 1, 1994).
	STS	Zakon Rossiyskoy Federatsii "O gosudarstvennoy nalogovoj sluzhbe RSFSR"(s izmeneniyami i dopolneniyami na 25 Fevralya 1993 goda) ot 3/21/91 N 943-1 (Law of the Russian Federation "On the State Tax Service of the RSFSR" (with amendments to Feb. 25, 1993)). Prinyat Verkhovniy Sovet Rossiyskoy Federatsii Data redaktsii 2/25/93. Vedomosti S'ezda narodnykh deputatov RSFSR i Verkhovnogo Soveta RSFSR, 1991, N15, st. 492.

IT	Law of the RSFSR on Income Tax from Physical Persons; *reprinted in* "Vse Nalogi Rossii," Feb. 1992, at 17–35 [in Russian]; *translated in* FBIS-USR-92-010-L, Sept. 17, 1992, at 32–43 [English trans.]. Law of the Russian Federation Concerning Income Tax from Physical Persons [English trans. by Ernst & Young] (as amended by the law of the Russian Federation of July 16, 1992 Concerning Amendments and Additions to the Taxation System of Russia).
IHT	Act Nº 2020-1 Russian Federation Tax on Property Transferred by Inheritance or Gift Act, Mar. 1993; *reprinted in* 2 Business and Commercial Laws of Russia: Business Enterprises, Privatization, Commercial Trade, McGraw-Hill [English trans.].
PT	Law of the RSFSR on Income (Profit) Tax from Enterprises; *reprinted in* "Rossiyskaya Gazeta," Mar. 12, 1992, at 3 [in Russian]; *translated in* FBIS-USR-92-054, May 5, 1992, at 20–27 [English trans.]. Law Nº 2116-1 of the Russian Federation of Dec. 27, 1991, Concerning Tax on the Profit of Enterprises and Organizations [English trans. by Ernst & Young] (as amended through Law Nº 54-FZ of the Russian Federation of Dec. 3, 1994 Concerning the Introduction of Amendments and Additions to the Law of the Russian Federation Concerning Tax on the Profit of Enterprises and Organization).
	Federal Law Nº 64-FZ of the Russian Federation of Apr. 25, 1995, Concerning the Introduction of Amendments and Additions to the Law of the Russian Federation Concerning Tax on the Profit of Enterprises and Organizations [English trans. by Ernst & Young].
TAE	Law Nº 2030-1 of the Russian Federation of Dec. 13, 1991, Concerning Tax on the Assets of Enterprises [English trans. by Ernst & Young] (as amended through Federal Law Nº 37-FZ of the Russian Federation of Nov. 11, 1994, Concerning the Introduction of Amendments and Additions to Certain Tax Laws of the Russian Federation and Concerning the Establishment of Exemptions in Relation to Compulsory Payments to State Non-Budgetary Funds).
VAT	Law Nº 1992-1 of the Russian Federation of Dec. 6, 1991, Concerning Value Added Tax; *reprinted in* "Ekonomicheskaya Gazeta" Nº 1, Jan. 1992 [in Russian]; [English trans. by Ernst & Young] (as amended through Federal Law Nº 54-FZ of the Russian Federation of Dec. 6, 1994, Concerning the Introduction of Amendments and Additions to the Law of Russian Federation Concerning Value Added Tax).
	Federal Law Nº 63-FZ of the Russian Federation of Apr. 25, 1995, Concerning the Introduction of Amendments and Additions to the Law of the Russian Federation Concerning Value Added Tax [English trans. by Ernst & Young].

Sierra Leone SLE	IT	Income Tax Act, Nº 1 of 1943, ch. 273; *reprinted in* The Income Tax Act (as amended to Dec. 31, 1992) (unofficial consolidation).
Singapore SGP	GST	Act Nº 31 of 1993, The Goods and Services Tax Act 1993; *reprinted in* Singapore, Government Gazette Acts Supplement, Nº 28, 1993.
	ED	Act Nº 19 of 1931 Estate Duty Act, as amended through Act Nº 14 of 1984, Cap. 96; *reprinted in* The Statutes of the Republic of Singapore, Government Printer, 1985 rev. ed.
Slovak Republic SVK	TAL	Zákon o daňových poradcoch a Slovenskej Komore daňových poradcov (Law on Tax Advisers and the Slovak Chamber of Tax Advisers) Nº 78, Jan. 29, 1992, 1992 zb. částka 20, strana 507 [in Slovak].
	INH	Zákon o Dani z Dedičstva, Dani z Darovania a Dani z Prevodu a Prechodu Nehnuteľností (Law on Inheritance Tax, Gift Tax and the Tax on the Transfer of Real Property), Zákon Slovenskej narodnej rady c.318/1992 Zb. of May 4, 1992; *reprinted in* Sústava Daní a Poplatkov od roku 1993, at 79 (Ing. Jozef Torják, CSc. a kolektiv 1993) [in Slovak].
Slovenia SVN	TC	Zákon o davkih občanov (Law of Tax on Citizens) of Sept. 28, 1988, Official Gazette Uradni List Nº 36 of Oct. 21, 1988, as amended by Law Nº 343 Official Gazette Nº 8, Mar. 3, 1989, and Law Nº 300 Official Gazette Nº 7 of Feb 4, 1993 [in Slovenian].
South Africa ZAF	VAT	Act Nº 89 Value Added Tax Act, 1991, Government Gazette Nº 13307 of June 12, 1991.
Spain ESP	LGT	Ley General Tributaria (General Tax Law), B.O.E. del 31 de diciembre de 1963; *reprinted in* 1 Leyes Tributarias, Legislación Básica 27 (5th ed., Spain, Ministerio de Economía y Hacienda 1993) (as amended to Dec. 30, 1992) [in Spanish].
	IRPF	Ley 18/1991, del 6 de junio, del Impuesto sobre la Renta de las Personas Físicas (Personal Income Tax Law), B.O.E. del 7 de junio y del 2 de octubre de 1991; *Id.* at 469.
	IS	Ley 61/1978, del 27 de diciembre, del Impuesto sobre Sociedades (Corporation Tax Law), B.O.E. del 30 de diciembre de 1978; *Id.* at 655.
	IP	Ley 19/1991, del 6 de junio, del Impuesto sobre el Patrimonio (Law Governing Wealth/Property Tax), B.O.E. del 7 de junio y del 2 de octubre de 1991; *Id* at 883.
	ISD	Ley 29/1987, del 18 de diciembre, del Impuesto sobre Sucesiones y Donaciones (Law Governing the Tax on Bequests and Gifts), B.O.E. del 19 de diciembre de 1987; *Id.* at 911.
	IVA	Ley 37/1992, del 28 de diciembre, del Impuesto sobre el Valor Añadido (Value Added Tax), B.O.E. del 29 de diciembre de 1992, B.O.E del 8 de febrero de 1993; *Id.* at 1113.

Sweden SWE	AAR	Act on Advance Rulings in Questions Relating to Tax Assessment (SFS 1951:442) [English trans.].
	SF	Lag upphävande av lagen (1947: 577) om statlig förmögenhetsskatt (1991:1850) (Law (1991:1850) repealing Law on State Wealth Tax); *reprinted in* Skatte-och taxerings-orfattringarna (Skattefövaltningen, Riksskatterverket (as amended to Jan. 1, 1992) at 463 [in Swedish].
		Lag om statlig förmögenhetsskatt (Law (1947:577) on State Wealth Tax); *Id.*
	AGL	Lag om arvsskatt och gåvoskott, 1941 (Law on Inheritance and Gift Tax).
Switzerland CHE	OTVA	Ordonnance régissant la taxe sur la valeur ajoutée (Value Added Tax) of June 22, 1994; *reprinted in* 6(2) Recueil Systématique du Droit Fédéral, at 641.201.
Togo TGO	CGI	Code Général des Impôts (General Tax Code); *reprinted in* Ministère de l'Economie et des Finances, Code Général des Impôts (1985) [in French].
United Kingdom GBR	TMA	Taxes Management Act 1970; *reprinted in* Great Britain, Board of Inland Revenue, 1 The Taxes Acts: Income Tax, Corporation Tax and Capital Gains Tax (HMSO 1994) (as amended to 1994).
	ICTA	Income and Corporation Taxes Act 1988; *reprinted in* Great Britain, Board of Inland Revenue, 1 and 2 The Taxes Acts: Income Tax, Corporation Tax and Capital Gains Tax (HMSO 1994) (as amended to 1994).
	VAT	Value Added Tax Act 1994; *reprinted in* The Law Reports Statutes 1994, pt. 5, The Incorporated Council of Law Reporting for England and Wales, Cap. 23, at 1393.
	IHT	Inheritance Tax of 1984; *reprinted in* 43 Halsbury's 1068 and Orange Tax Handbook, Butterworths, 1995–96, at 46.
United States USA	IRC	Internal Revenue Code; *reprinted in* The Complete Internal Revenue Code: All the Income, Estate, Gift, Employment, Excise, Procedure and Administrative Provisions (Research Institute of America, Inc. 1995) (as amended to Dec. 31, 1994).
Venezuela VEN	COT	Código Orgánico Tributario (General Tax Code), G.O. Nº 2.992 Extraordinario del 3 de agosto de 1982 [in Spanish].
	IR	Ley de Impuesto sobre la Renta (Income Tax Law), Gaceta Oficial de la República de Venezuela of Sept. 9, 1993 [in Spanish]; *reprinted in* 45 TLW (as amended to Dec. 1993) [English trans.].
		Decreto Nº 3113 Ley de Reforma Parcial de la Ley de Impuesto sobre la Renta (Law on the Partial Reform of the Income Tax Law), del 26 de agosto de 1993, Gaceta Oficial Nº 4.628 Extraordinario del 9 de septiembre de 1993 [in Spanish].

ATL	Decreto Nº 3.266 Ley de Impuesto a los Activos Empresariales (Law on the Tax on Business Assets), del 26 de noviembre de 1993, Gaceta Oficial de la República de Venezuela Nº 4.654 of Dec. 1, 1993 [in Spanish].
IC	Decreto que Establece el Impuesto al Consumo Suntuario y a las Ventas al Mayor (Decree Establishing a Tax on Luxury Consumption and Sales at Wholesale), Gaceta Oficial de la República de Venezuela of May 27, 1994 [in Spanish].

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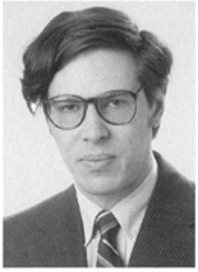
Biographical Sketches

EDITOR



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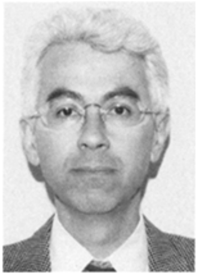

Graeme Cooper is an associate professor of law at the University of Sydney, where he specializes in taxation law and policy. He is currently on leave from the university to work in the Fiscal Affairs Division of OECD, Paris, in the Unit for Cooperation with Economies in Transition and Non-Member Countries. His work with OECD involves providing advice and training to officials from the governments of emerging market economies in Eastern Europe and Central Asia. He has also worked as a consultant to the IMF and as a member of various advisory committees to the Australian Government and the Australian Taxation Office. He has studied and taught at universities in Australia and the United States and is the author of several books on taxation as well as many articles in Australian and international journals.

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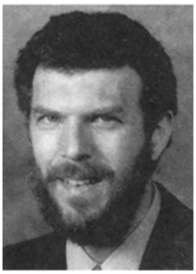
Richard Gordon has been an advisor to the Legal Department of the IMF since 1995. After graduating from Yale University and Harvard Law School, he practiced law at the firm of Dewey Ballantine and taught at the School of Oriental and African Studies at the University of London. In 1990, he became deputy director of the Harvard International Tax Program and an associate at the Harvard Institute for International Development, and in 1991 became lecturer in law at the Harvard Law School. Mr. Gordon has participated in many tax and economic reform projects in developing and transition countries and is the author of a number of articles on taxation and on law and development. He is one of the world's finest practitioners of Punjabi cooking.

David Holland received a master's in science in mathematical economics and econometrics from the London School of Economics. After teaching there and at Dalhousie University, he joined the Ministry of Finance in the Canadian Government, where during the course of a career spanning 17 years he held a variety of senior policy positions, including Director of Business Taxation and General Director of the Tax Policy Branch. In these positions, he was intensively involved in the reform of the Canadian tax system. In 1993, he joined the OECD's Unit for Cooperation with the Economies in Transition and Other Non-Member Countries, which he currently directs.



Rick Krever holds a law degree from Osgoode Hall Law School and a master's in law from Harvard Law School. Formerly a reader at Monash University, Professor Krever was appointed to a chair at Deakin University in 1993, where he teaches in the school of law and acts as director of the university's Taxation Law and Policy Research Institute. Professor Krever served as a visiting consultant to the IMF in 1994 and has participated in Fund missions providing taxation law drafting advice to a number of member countries. He has also acted as a consultant to the treasuries of Australia and New Zealand and is currently a member of a consultative committee advising the Australian Government on the redrafting of that country's income tax legislation. Professor Krever's published works include a taxation law casebook, *Income Taxation Commentary and Materials*, of which he is a coauthor (Law Book Company, 1989 and 1993) and a taxation law and policy text, *Australian Taxation: Principles and Practice*, of which he is the editor and a contributor (Longman, 1987).

Rebecca S. Rudnick received her undergraduate degree in economics and English from Willamette University, her law degree from the University of Texas School of Law, and a master's degree in tax law from New York University School of Law. She has practiced tax law in New York City, served as special counsel to the New York State Legislative Tax Study Commission and as professor-in-residence in the Office of Chief Counsel of the U.S. Internal Revenue Service, and has taught tax law at a number of U.S. law schools since 1985. Professor Rudnick, who is currently visiting at the University of Pennsylvania Law School, has participated in legislative drafting and advising on developing and transition

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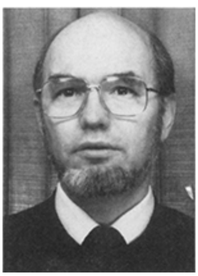
Frans Vanistendael studied law and economics at K.U. Leuven in Belgium and received a master's in law from Yale. He is a professor of taxation at K.U. Leuven and a member of the Brussels bar. He was Royal Commissioner of Tax Reform in Belgium (1987–88) and a member of the Ruding Committee on European Tax Harmonization (1991–92). Mr. Vanistendael has participated in Fund missions to Eastern European countries and China and has worked as a consultant in tax administration with the OECD.

Richard Vann is a professor of law at the University of Sydney, where he has taught for 20 years mainly in international and corporate taxation. From March 1990 to February 1991, he worked as Counsel (Taxation) in the Legal Department of the IMF, drafting tax laws for developing and transition countries. From September 1992 to January 1995, he was head of Central and Eastern Europe and NIS Programme, Fiscal Affairs Division, OECD, where he ran a technical assistance program for countries in this region. He currently acts as a consultant to the IMF, the OECD, the Australian Taxation Office, and Greenwoods & Freehills, Taxation Consultants, Sydney. He is a member of the Global Law Faculty of New York University. Professor Vann is editor of *Australian Tax Forum* and a governor of the Australian Tax Research Foundation. He has previously served on the Taxation Committee of the Law Council of Australia and the N.S.W. State Council of the Taxation Institute of Australia. He has edited and published several books on taxation, including *Company Tax Reform*, *Income Taxation Commentary and Materials*, *Trans-Tasman Taxation of Equity Finance*, and *Measuring Income Under Inflation*. Over the years he has published many articles in all areas of taxation.



David Williams holds a master's degree in law and a doctorate in philosophy from the University of Bristol. He is a solicitor of the Supreme Court of England and Wales and an associate of the Chartered Institute of Taxation. He holds the professorship in tax law at the Centre for Commercial Law Studies, Queen Mary and Westfield College, University of London. Mr. Williams has been involved in international taxation for over a decade as an academic and in working for the IMF, the OECD, the EU, and governments. His publications include *Trends in International Taxation* (1991), *The National Insurance Contributions Handbook* (loose-leaf), and a range of other books and articles for both professional and popular readerships.

Joan Youngman received her undergraduate degree in social studies from Harvard University and her law degree from Harvard Law School. She has practiced tax law with the Boston firm of Hale and Dorr and served as a research associate at the Harvard Law School International Tax Program, where she is currently a research fellow. Since 1990, she has held the position of senior fellow with the Lincoln Institute of Land Policy in Cambridge, Massachusetts. Ms. Youngman has participated in international missions for the Fund and for USAID involving legislative drafting and

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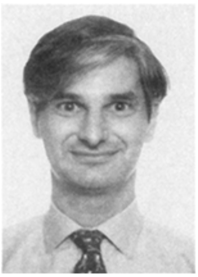

Eric Zolt is a professor at the University of California, Los Angeles School of Law. He received his undergraduate degree in economics from the Wharton School, University of Pennsylvania, and his graduate business degree and law degree from the University of Chicago. Before joining UCLA, he was a partner in the Chicago law firm of Kirkland & Ellis. Professor Zolt served in the Office of Tax Policy, U.S. Department of Treasury from 1989 through 1992, first as Deputy Tax Legislative Counsel and then as the Director of Treasury's Tax Advisory Programme for Central and Eastern Europe and the Former Soviet Union.

This book considers the development of tax legislation from a comparative law perspective. It grows out of the IMF Legal Department's experience in assisting many developing and transition countries with the drafting of tax legislation, and distills from this experience practical guidelines for officials and their advisors. In addition, the book should be of interest to students, academics, and practitioners with an interest in comparative tax law. It covers a wide range of subjects, from the legal framework for taxation to VAT, and includes such specialized topics as inflation adjustment. A forthcoming companion volume focuses on income taxation.

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